
Assessing the market for standalone fixed telephone services

Is Ofcom's approach robust from an
economics perspective?

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Executive summary

BT has asked Oxera to analyse whether Ofcom's approach in the standalone landline market review is robust from an economics perspective.

Ofcom's primary concern relates to the perception that customers who do not purchase fixed voice services in bundles have not benefited from competition in retail telecoms markets to the same extent as customers who do purchase bundles. In particular, Ofcom has expressed concerns with the levels of engagement displayed by customers of a voice-only service and those who purchase voice and broadband outside of a bundle—denoted as standalone fixed voice (SFV) customers.¹

Ofcom has provisionally determined that the cause of these concerns is BT's position of significant market power (SMP) in a narrowly defined retail market for the provision SFV services (in regard to both access and calls). It has therefore proposed a package of remedies that includes a cut in BT's standard line rental of at least £5 per month. The line rental price would then be subject to a cap that can only rise in line with inflation. BT would also be required to work together with Ofcom to trial ways of communicating with SFV customers in order to increase their levels of engagement in the market.

However, our assessment of the evidence and arguments presented by Ofcom finds that, in so far as there is an issue of certain customer segments not benefiting from competition to the same extent as others, or differences in the level of engagement by certain consumer segments, these are market-wide features that are not caused by the actions or behaviours of a particular operator (BT in this case). We therefore conclude that it is not proportionate or reasonable to impose retail-based SMP obligations on a single provider (in this case BT) to address the alleged concerns.

Furthermore, our analysis also finds a number of shortcomings with Ofcom's approach and conclusions.

First, Ofcom fails to recognise that the pricing structure that it is concerned with (low pricing for bundles via low incremental broadband price, and relatively higher line rental prices) is a direct consequence and a rational response to intense competition in retail markets. It is also a market-wide pricing strategy. As such, the concern raised by Ofcom is not caused by the actions of a dominant operator exploiting its customers, but rather a rational response by all firms to effective retail competition for bundles.

As a result, Ofcom's approach to market definition does not provide an appropriate framework for assessing the concerns it has raised. We consider that a broader framework taking account of these market-wide pricing practices would be more appropriate, both to understand the nature of any concern, taking account of all relevant competitive dynamics, and to ensure that any intervention is appropriate and can address the identified concern in a proportionate way.

Second, Ofcom also fails to take account of how the intervention by the Advertising Standards Authority (ASA) preventing communications providers (CPs) from splitting out the line rental and broadband prices in dual play bundles will go a long way towards addressing Ofcom's alleged concerns. This is

¹ See Ofcom (2017), 'BT's landline-only customers set for cheaper bills', press release, 28 February, which states as one of the headline bullet points that 'Landline-only customers are often elderly or vulnerable, unlikely to switch'.

because the incremental broadband price will no longer be the focus of competitive offers. As a consequence, CPs may lower the standalone line rental price as a further means to compete for these customers because the implicit rise in the incremental broadband price will no longer be directly visible to dual play customers, reducing the risk of uncompetitiveness in the dual play market from such a strategy.

Nevertheless, providers may still wish to balance this opportunity for greater headline price competition targeted at those who are unlikely to take up broadband, with a desire to keep implicit broadband prices low in order to drive further migration to bundles for those who might still migrate.

Third, the market identified by Ofcom is declining rapidly and may soon cease to exist altogether as a result of natural churn and continued migration to bundles. This calls into question the proportionality of reintroducing retail SMP remedies at this point.

Fourth, in relation to Ofcom's approach to market definition and market power, our analysis finds that the regulator has failed to take account of the principles of price discrimination in the context of market definition. This has implications for Ofcom's conclusion that SFV access and calls constitute separate relevant economic markets. Robustly viewed, the significant migration of SFV customers towards bundles reveals that the boundaries of the market that Ofcom has identified are not stable. This is an important condition (both theoretically and in practice) for separating relevant markets into narrow segments.

Fifth, the separation by Ofcom of split purchase and dual play customers is incorrect. Split purchase customers should be part of the same market as dual play customers: we reach this conclusion on the basis of: i) both sets of customers consuming a functionally equivalent service; ii) both sets of consumers having very similar (demographic, mobile usage, and market engagement) characteristics. Furthermore, a large number of split purchase customers are engaged in the market and are already optimising their service consumption decision. Ofcom's concerns in relation to this customer segment are, therefore, unfounded.

Having incorrectly defined narrow SFV markets, Ofcom then finds that BT has SMP. Even within these incorrectly defined markets, we find that Ofcom has not fully accounted for the competitive constraints that BT faces in respect of the voice-only customer segment. This results in an overstatement of the degree of market power that BT would have in relation to voice-only customers. In particular, BT faces constraints both from mobile substitution and from rivals with strong brands and competitive advantages, such as the Post Office, which is competing actively for voice-only customers.

As a direct result of these shortcomings, Ofcom's proposals to remedy the alleged concerns are inappropriate, for a number of reasons:

- SMP has not been properly substantiated for the reasons give above, and therefore there is no clear basis for SMP regulation;
- Ofcom's approach reduces its flexibility in choice of remedy—market-wide remedies are artificially ruled out. This is inappropriate because the concerns identified by Ofcom (although not properly substantiated) are market-wide in nature;
- the remedies that Ofcom does propose are disproportionate and would have unintended consequences. In particular, we note that:

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- i) Ofcom's remedies are targeted solely at standalone fixed voice customers and only at BT, when in practice, a significant proportion of the customers Ofcom is concerned about are split purchasers, who pay *the same* line rental as dual play customers. Given that the line rental is the same in the two cases (which Ofcom itself assumes in its analysis of the savings from a split purchase customer moving to dual play), the saving from moving to dual play from split purchase is attributable to a saving on the broadband component. If the saving is attributable to the broadband component, it is not immediately clear why a remedy should be applied to the line rental (voice) component. However, this is precisely what Ofcom is proposing for these split purchase customers. Furthermore, it is proposing to apply such a remedy to BT only, which has only a small (less than 20%) share of the broadband component of split purchase customers. Therefore, not only is Ofcom applying remedies to the wrong product, but to the wrong firm—BT does not have SMP in standalone broadband;
- ii) Ofcom does not appear to have considered how a deep price cut on standalone line rental might affect the migration towards dual play bundles and digital inclusion. These unintended consequences, which could include slowing migration to dual play and possibly even reversing migration (as some dual play customers decide to switch back to split purchase or even voice only) could ultimately be detrimental.
-

1 The market context

In this section we set out the relevant market context which should inform an assessment of standalone fixed voice services.

The main arguments we develop in this section are as follows.

- **Price competition occurs at the level of the wider market, and has been targeted at broadband, which provides a pro-competitive explanation for the pricing structure that Ofcom is concerned about:** we set out why competition has historically focused primarily (but not exclusively) on incremental broadband prices within a dual play bundle. This explains what we see in the market, with very low incremental broadband prices offset by line rental prices. Overall, however, competition between dual play bundle providers results in margins that are consistent with a contestable and highly competitive market.
- **Obligations recently imposed by the Advertising Standard Authority may alone address the concern Ofcom raises:** the new advertising rules (which came into force in October 2016) no longer allow operators to advertise the price of broadband separately from the inclusive (and requisite) line rental, instead the total dual play bundle price must be presented. This means that lowering line rental prices may become a further means to compete for voice-only customers alongside product innovation and discounts (although dual play providers may still balance this with promoting further uptake of bundles by keeping implicit broadband prices low). As a result, the market-wide pricing structure Ofcom has identified as being problematic for voice-only customers may be (at least partly) addressed by the new ASA rules.
- **The markets identified by Ofcom are declining rapidly:** the concern identified by Ofcom is in relation to a rapidly declining segment. As such, any concern will be transitory, which brings into question the proportionality of Ofcom's proposed remedies.
- **The concern Ofcom alleges is a market-wide feature, not BT-specific:** both the nature of competition in the market (historically based around low incremental broadband prices), and the level of engagement exhibited by certain consumer segments, are market-wide features, and are not caused by the actions or behaviours of a specific firm in the market. It is therefore not proportionate or reasonable to impose retail-based obligations on a single provider (in this case BT) to address the alleged concerns.

1.1 Price competition occurs at the level of the wider market, and has been targeted at broadband, which provides a pro-competitive explanation for the pricing structure we have observed

In this section we set out how competition in the wider market has focused on bundles, and why that has led to the outcome now observed, including the concern that Ofcom has raised.

Bundling

Ofcom itself recognises that since the removal of regulation in retail voice telephony markets in 2009, many consumers have moved towards buying services in bundles and ‘this is where we have seen the focus of competition.’²

Indeed, as Ofcom notes, in 2016,³ 68% of households reported buying at least two of their communication services in a bundle, with dual play packages of landline and broadband and triple play packages of landline, broadband and pay-TV being the most popular; furthermore, this percentage keeps rising.

Most starkly, almost 9 out of 10 people taking voice services do so in a bundle.⁴ Ofcom itself notes that the number of customers who take voice services in a bundle is increasing over time.

Bundling can be beneficial to firms and consumers. The benefits of bundling are well understood; bundling can expand output, increasing efficiency relative to standalone pricing.⁵

Furthermore, a key consideration related to pricing by high fixed-cost, multi-product firms is the optimal recovery of costs.

For such firms, an important question is how they can efficiently recover their costs of providing the range of products and services in their portfolio.

Ofcom has long recognised the importance of efficient cost recovery, and allowing firms (even under a charge control) pricing flexibility to recover costs from different products in order to maximise overall efficiency.

Use (historically) of low incremental broadband prices

On the basis that 9 out of 10 customers buy fixed voice as part of a bundle (and this proportion is set to increase in the future), it is not surprising that operators in the market have structured their pricing policies on the basis of bundle purchasing. This is indeed recognised by Ofcom, which notes that the incremental broadband price within a bundle has generally been the focus of competitive activity for bundles and has declined significantly.⁶

Broadband marketing material illustrate how operators have historically opted to present low incremental broadband prices as a marketing tool to attract consumers for whom this is a key driver, as shown in the examples below.

² Ofcom (2017), ‘The review of the market for standalone landline telephone services: Provisional conclusions’, 28 February, para. 2.2. Hereafter referred to as ‘RMSLTS’.

³ Ofcom (2016), ‘Communications Market Report’, section 1.3.4, <https://www.ofcom.org.uk/research-and-data/cmrr/cmrr16> accessed 8 May 2017. Hereafter referred to as ‘CMR’.

⁴ Currently 2.9m households take voice services outside a bundle, representing 11% of all residential landline users (i.e. including those who purchase landline services in a bundle). This means that 89% of all residential landline users take voice in a bundle.

⁵ The use of bundling as a means of efficient price discrimination is well explored in economic literature. See, for example, Motta, M. (2004), *Competition Policy: Theory and Practice*, Cambridge University Press, section 7.3.

⁶ Ofcom (2017), ‘RMSLTS’, para. 3.34.

Unlimited Broadband
A perfect package for large families, downloaders and gamers.

up to **17Mb** download speed

with **unlimited** monthly usage

from ~~£9.99~~ **£2.50** a month* for 12 months

–£15.95 monthly line rental

Start your order

Weekends
Calls to 01, 02 & 03 UK landline numbers at any time on weekends.

weekends inclusive calls to UK landlines

free calls to Plusnet Phone customers

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Plusnet 2015 offer

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Download all the music to keep you dancing with totally unlimited broadband and we'll never slow you down, even at peak times.

New to Sky

£3.75 a month for 12 months
(then £7.50 a month)
+ Sky Talk & Line Rental (at £16.40 a month)

Select & personalise



TalkTalk

Hurry sale ends 10 July

TalkTalk's **HALF PRICE BROADBAND SALE**

Totally Unlimited Broadband
~~£3.50~~ **£1.75** a month for 6 months
+ £15.95 monthly line rental

SAVE £100's BT every 6 months

£75 VOUCHER

Buy now

TalkTalk 2014 offer

Low incremental pricing of broadband (within bundles) is likely to encourage take-up of broadband, since consumers will consider the incremental broadband price when deciding whether to add it to their fixed voice service (i.e. the price–quality trade-off referred to by Ofcom at paragraph 3.35.1).⁷

As such, the pricing structure that Ofcom is concerned about is clearly a key pricing (and marketing) strategy for all operators in the market. Indeed, in certain cases, broadband is given away for free—for example, Sky has offered free broadband for 12 months to customers taking up a pay-TV package with Sky Sports.⁸ Offering a service for free acts to highlight the strategic pricing practices employed in this market.

Such practices could be used by communication providers (CPs) that wish to attract customers into one service in order to on-sell them another service. In the above example, Sky can use broadband as a 'carrot' to entice customers onto its high-margin pay-TV business.

A pricing strategy based on low incremental pricing is not unique to broadband (or telecoms markets in general). It can be seen in many markets as a strategy

⁷ For information on incremental broadband trends, see OECD (2011), 'Broadband Bundling: Trends and Policy Implications', <http://www.oecd.org/internet/broadband/47180401.pdf>, accessed 8 May 2017.

⁸ <http://broadbandinternetuk.com/blog/2233/sky-comnewseason-free-broadband-with-sky-sports>, accessed 8 May 2017

to expand consumption, for example to encourage the take-up of add-on services.⁹ It also allows pricing to better reflect relative valuations for different bundle elements that might be highly differentiated between different customers.

Such strategic pricing can expand consumption and promote competition between firms and deliver benefits for customers. Indeed, this is exactly what has happened in UK retail telecoms markets, where Ofcom itself notes that the UK ranks first against close EU comparators in relation to many telecoms service metrics, including: percentage of individuals accessing the Internet at least once per week; broadband connections above 30Mbps; and the weighted average bundle pricing for fixed broadband and fixed voice services.¹⁰

In this light, it becomes clear why a firm specialising in broadband bundles (such as TalkTalk) would not wish to lower its price for landline in order to directly target voice-only customers (and would instead prefer to maintain relatively high line rental charges but very low incremental broadband prices). Doing so would hamper its ability to compete for customers of broadband bundles, which are by far the largest customer segment (equating to approximately 90% of customers, and growing).¹¹

Such a strategy would also explain why firms in the market have moved to increase line rental in order to compete in low incremental broadband prices—i.e. it is the outcome of fierce competition for the broadband incremental price.¹²

From this perspective, the market outcome does not result from targeted abuse by a dominant firm, but is more a question of whether a cohort of consumers (i.e. standalone fixed voice customers) are sharing in the benefits delivered by competition as much as other groups. In other words, the issue is how the benefits of competition are being distributed and not a question of abuse of market position.

Finally, in the overall market for both voice and broadband, high levels of competition (most especially for dual play bundles) have ensured significant benefits to consumers, and margins for CPs that are not excessive (with an EBIT margin of between [x] and [x] according to Ofcom's analysis).¹³

Given the pricing strategy described above, and the market context in this case, it would not be appropriate to focus on the profits earned in a narrow segment of the market.

⁹ Low incremental pricing can be seen in the transport sector, where volume discounts are prevalent. The cost of a return travel ticket is often less than that of two one-way tickets, resulting in a low incremental price for the return journey. This is good for consumers, who benefit from the lower incremental price and may choose to make more journeys as a result. Another example can be seen in the food industry, such as for cinema popcorn, whereby significantly larger bags of popcorn are sold at only slightly higher prices.

¹⁰ See:

https://www.ofcom.org.uk/data/assets/pdf_file/0036/79956/european_broadband_scorecard_2015.pdf accessed 8 May 2017.

¹¹ Furthermore, owing to the high level of competition in the dual play market there is little scope to undercut competitors.

¹² As an example, we note that TalkTalk has continually dropped the incremental broadband price (in real terms). If we take the average price paid per month over the first 12 months, we get £5.25 per month in 2010, £3.25 per month in 2013 and £0 per month in 2016. (TalkTalk offered free broadband for the first 12 months.) This change over time is matched closely by the reverse change in line rental, which increased from £11.49 in 2010, to £14.95 in 2013 and £17.70 in 2016. This information was acquired via the WayBackMachine (<https://web.archive.org/>).

¹³ Ofcom. RMSLTS consultation, paragraph A5.81.

1.2 Obligations recently imposed by the Advertising Standards Authority may alone address the concern Ofcom raises

Given the above context, a key market change has occurred which creates further opportunities for competition to deliver benefits to voice-only customers: the intervention by the Advertising Standards Authority (ASA) to ensure that broadband prices cannot be advertised separately from line rental charges.¹⁴ Ofcom has failed to take such market dynamic effects into account in its assessment.

The obligations imposed on broadband providers by the ASA (which came into force on 31 October 2016) stipulate that the all-inclusive dual play price (i.e. including line rental) must be presented in marketing materials without line rental being presented separately. See examples below:



Add more to your plan
Choose your broadband speed:

<p>Fast Broadband up to 17Mb</p> <p>£22.95 a month + FREE set-up</p>	<p>Faster Fibre up to 38Mb</p> <p>£27 a month + FREE set-up</p>	<p>Faster Fibre up to 76Mb</p> <p>£32 a month + FREE set-up</p>
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TalkTalk website,
April 2017

Sky website,
April 2017

<p>Broadband Unlimited</p> <p>Find out more ></p> <p>UNLIMITED</p> <p>£18.99 p/m for 12 months £9.95 setup costs 12 month contract</p> <p>Buy now ></p> <p>See All Sky deals ></p>	<p>Original Bundle + Broadband Unlimited</p> <p>Find out more ></p> <p>UNLIMITED</p> <p>£45.99 p/m for 18 months £39.95 setup costs 18 month contract</p> <p>Buy now ></p> <p>See All Sky deals ></p>	<p>Fibre Unlimited</p> <p>Find out more ></p> <p>UNLIMITED</p> <p>£30.00 p/m for 18 months £48.95 setup costs 18 month contract</p> <p>Buy now ></p> <p>See All Sky deals ></p>
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As a result of these changes, and the new form that price competition will (and must) now take going forward (on the basis of the full dual play bundle price), the incentives to compete in the voice-only segment are materially increased, in that they are less affected by the impact on what were formerly headline incremental broadband prices.

In fact, going forward, lowering line rental prices provides a further means to compete for voice-only customers alongside product innovation and discounts (although dual play providers may still balance this with promoting further uptake of bundles by keeping implicit broadband prices low). The logic for this can be set out in four steps:

¹⁴ <https://www.asa.org.uk/news/tougher-approach-to-broadband-price-claims-in-ads.html> accessed 8 May 2017.

1. the vast majority of consumers value and wish to purchase broadband. As such, it was rational for CPs to advertise the broadband component of dual play bundles at a low price. In order to maintain overall margins (which are competitively constrained), the low broadband incremental price could be offset by the line rental fee (although BT also created tailored products to protect voice-only customers from these effects, under competitive pressure from other voice-only providers);
2. one way to compete for voice-only customers would have been to reduce landline prices, and therefore increase the broadband incremental price (in order to maintain overall bundle margins). Owing to this trade-off (rebalancing), competing in the voice-only segment (of 2.9m customers, if we include split purchase customers) could inhibit a CP's contestability for the much larger (approximately 28m) dual play segment.
3. Now that dual play bundles are advertised as a single price (following the ASA requirements), price competition can no longer focus on low incremental broadband prices but rather the entire bundle price must be presented. The constituent prices for the dual play offering (broadband and voice) are, therefore, no longer relevant from a marketing perspective.
4. Given this new paradigm of price competition, headline line rental price reductions may be more likely to be used as a further means of competing in the voice-only segment. That is, CPs may now be more relaxed about an implicit increase in the incremental broadband price, to offset a decrease in the line rental price (to maintain overall margins) because it is no longer the focus of price competition, although it remains a relevant pricing parameter in driving uptake of bundles.

1.3 The SFV segment is declining rapidly

We set out below why, owing to the significant forecast declines in SFV customers (as a result of migration to bundles and natural churn), intervention is unlikely to be proportionate.

Ofcom notes that BT has a high share of customers (70%) in the market that Ofcom defines for SFV services.¹⁵

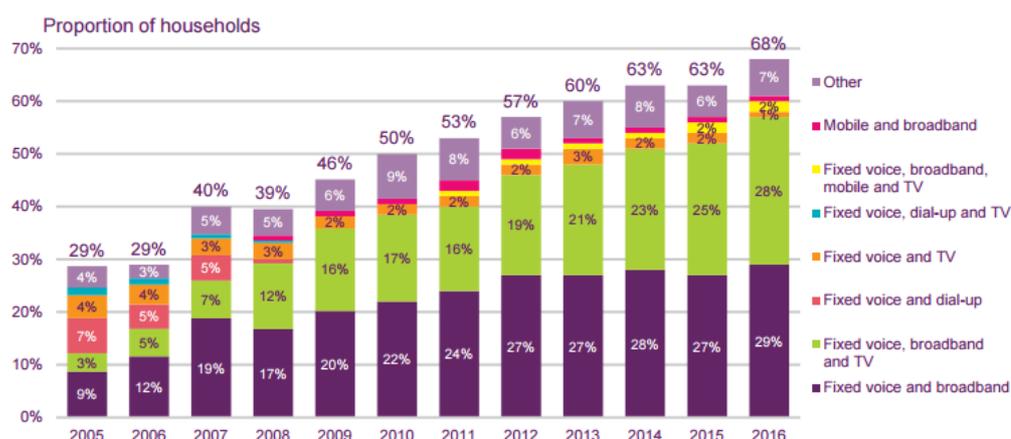
However, the market has been declining as consumers: switch to dual play bundles; cease to need a service altogether; or in the case of customers not requiring fixed broadband, substitute to mobile voice services from fixed (for either calls or access).¹⁶

Ofcom notes that the rate of year-on-year decline has been decreasing.¹⁷ However we anticipate that the base will continue to decline, particularly as the SFV base continues to migrate to bundles. This is in line with Ofcom's own analysis which demonstrates the growing trend of consumers taking bundled services and in line with historical trends. We present this in Figure 1.1 below.

¹⁵ This is an average across all SFV customers. It is made up of a lower share of voice-only customers, around 60%, and a higher share for split purchase customers. However, as we set out in section 2.2, the latter should not be included in this narrow market, and therefore the figure of 70% is inflated.

¹⁶ As Ofcom points out, the number of SFV lines decreased from 6.1m in Q1 2013 to 2.9m in Q3 2016—i.e. by 52%. See Ofcom (2017) 'RMSLTS', para. A8.15.

¹⁷ For the market as a whole Ofcom calculates a decrease in the rate of decline from 23% in the year before Q4 2014 to 15% in the year before Q3 2016. For BT, Ofcom calculates a smaller decrease, from 25% in the year before Q1 2014 to 17% in the year before Q3 2016. Ofcom notes in particular that BT's rate of decline is on average 11 percentage points faster than that of other CPs. See Ofcom (2017), 'RMSLTS', para. A8.17.

Figure 1.1 Take-up of bundles services

Source: Ofcom (2016), 'RMSLTS', Figure 1.6.

In addition to the strong trend of customers migrating to bundles, we also note that the SFV segment is characterised by a degree of natural churn. The SFV customer base has a high proportion of elderly customers (see RMSLTS, Figure A8.47). In particular, among respondents whose age was known, more than a third were 80 years of age or older.¹⁸ At the same time, younger customers are less likely to buy SFV services. Indeed, respondents less than 44 years of age accounted for a mere 8% of responses. This suggests that the SFV customer base will decline substantially on the basis of remaining life expectancy.¹⁹

In light of the above, and making a number of conservative assumptions,²⁰ we estimate that the proportion of SFV lines over the total line rental lines in the market will almost halve by the end of 2020 (to less than 6.5% of total lines).²¹ On this basis we consider that the market is likely continue to decline rapidly as a result of both continued switching and natural churn.

We also note that Ofcom has set a precedent for deregulating declining market segments; that is, where Ofcom has identified a market power issue, and still chosen not to regulate.

In the 2016 BCMR, for example, Ofcom concluded that deregulation was appropriate on the basis of the decline in the use of legacy leased lines:²²

given the context that this is a legacy market, with rapidly declining volumes, we consider that it is appropriate to rely on ex post competition law rather than imposing ex ante regulation. Consequently, we have decided that the three

¹⁸ That is, 31% out of the 92% of respondents who provided information on their age. It is also worth noting that elderly respondents might be more likely than younger respondents to refuse to provide information about their age. See Ofcom (2017), 'RMSLTS', Figure A8.47.

¹⁹ For example, 17% of respondents whose age is known are 85 years of age or above. In 2014, of the total number of death registrations among this age group, 29% were between 85 and 87 years of age and 47% were between 85 and 89 years of age.

²⁰ For example, assuming the rate of decline in the SFV base continues to reduce for the next two years in line with historical trends, and that total fixed voice lines will grow in line with the growth in the number of households in the UK.

²¹ Assuming that the decline in SFV churn continues (as Ofcom states), and as such there remain some 1.8m SFV customers by the end of 2020, relative to 28.4m total retail lines.

²² Ofcom notes that BT has 'a high share of the supply of retail VLB TI (very low bandwidth traditional interface) leased lines'. See Ofcom (2015), 'Business Connectivity Market Review: Very low bandwidth leased lines', para. 5.17, https://www.ofcom.org.uk/data/assets/pdf_file/0033/69378/vlb_ti_retail_market.pdf, accessed 5 May 2017. As such, this example presents a similar context to the case at hand.

criteria test is no longer satisfied and this market therefore is no longer susceptible to ex ante regulation.²³

Furthermore, Ofcom also highlighted in this case that the trend of migration to other/better services (deemed to be competitive) was an important factor in its decision to deregulate:

as users can and are migrating to alternative services, and will increasingly do so over the market review period, any barriers to, and prospects for, the competitive provision of retail VLB services are now less relevant (para. 5.19)

The SFV segment is also small and declining, raising questions about the duration of any alleged issues identified by Ofcom, as well as the proportionality of any proposed intervention.

1.4 The alleged competition concern identified by Ofcom is market-wide, not BT-specific

As set out in section 1.1, the pricing strategy historically observed in the market (based on low incremental broadband prices) is market-wide.

Furthermore, Ofcom's alleged concern—that 'Standalone landline customers generally do not engage with the market'²⁴—is not a BT-specific issue, but a market-wide one (to the extent that it exists).

Other CPs are, therefore, highly relevant to any discussion about improving customer engagement for specific customer groups particularly in relation to split purchasers where BT holds a small market share of standalone broadband (as we discuss in section 2.5.1).

As regards any demand side considerations relating to customer engagement, it is not appropriate to apply an analytical framework that singles out one operator, when in fact any issue of this nature (which Ofcom has not properly substantiated) affects all operators, and does not relate to an abuse of market power (i.e. customers can be disengaged for reasons other than CPs abusing a strong market position).

Ofcom bases its finding that BT should be the target of SMP remedies on the data on engagement levels. It claims that the data shows that BT customers are 'less engaged compared to customers of other CPs'.²⁵ Ignoring the low sample size, we note that the data Ofcom presents does not support this conclusion. This is because BT has a high share of SFV customers (historically and currently); as such, the data presented by Ofcom distorts the indication of engagement between BT and other CPs.

If we imagine the stylised example of BT having 100 customers and TalkTalk having 10, and we assume that each year 10% of consumers switch provider (i.e. all consumers are equally engaged, regardless of their service provider), we would expect 10 of BT's consumers to switch to TalkTalk this year, and 1 TalkTalk consumer to switch to BT.

In this example, using Ofcom's formulation of the data (which it presents in Figure A8.52), Ofcom would say that 53%²⁶ of TalkTalk's customers are

²³ Ofcom (2016), 'Business Connectivity Market Review: Very low bandwidth leased lines', Statement, 28 April, para 3.22. https://www.ofcom.org.uk/data/assets/pdf_file/0018/63225/final-statement.pdf, accessed 5 May 2017.

²⁴ Ofcom (2017), 'RMSLTA', para. 1.13.

²⁵ Ofcom (2017), 'RMSLTA', para. A8.156.

²⁶ (10/19)=53%.

engaged (i.e. have switched in the last 12 months), whereas only 11%²⁷ of BT's customers are engaged. This statement distorts the reality in this example that all customers are equally engaged (irrespective of provider), and it is simply a result of asymmetry in the market shares that leads to an apparent asymmetry of engagement.

For the reasons above, many regulators have sought to tackle competition problems of this nature not by changing market structure but by stimulating greater customer engagement across the whole market.²⁸

1.5 Oxera's conclusion on the market context

We conclude that the concern Ofcom raises has likely arisen as a result of the historical pro-competitive pricing policies of CPs, which have opted to employ bundled pricing strategies, whereby broadband prices are marketed at a very low price.

Many millions of customers who were once SFV customers have migrated to dual play and thereby benefited from this price competition. For SFV customers who have not yet switched (the number of whom is continually declining), the question posed by Ofcom is whether they are sufficiently engaged, and able to access and realise the benefits of competition to the same extent as dual play customers, within both the SFV segment and the wider market.

We consider that it is not appropriate to attribute any competition issues arising from a lack of customer engagement to SMP for a particular operator (in particular, BT). Such issues are market-wide; observed outcomes reflect pro-competitive strategies as the market has evolved towards almost ubiquitous take-up of bundles, and any issue of this nature is unlikely to persist in any event. This is because, not only is the market declining rapidly (meaning that it may not be proportionate to intervene at all), but new regulations imposed by the ASA mean that bundle pricing policies that historically have placed significant emphasis on incremental broadband prices are no longer permitted.

As a result, there is a greater opportunity to compete for voice-only customers using headline line rental prices alongside other means of competing for these customers.

²⁷ (1/91)=11%.

²⁸ In section 2.1.3 below we describe recent examples in energy, retail banking and payment protection insurance.

2 Ofcom has reached the wrong conclusions on market definition and SMP

In this section we assess and critique the approach taken by Ofcom in respect of market definition and SMP. This is notwithstanding the overall conclusion we have reached in the previous section regarding the fact that an SMP framework is the wrong tool to address the alleged concerns Ofcom has identified.

Ofcom arrives at its final market definition via three steps:

1. dual play customers are not in the same market as voice-only customers. RMSLTS, paras 3.30–3.38;
2. dual play customers are not in the same market as split purchasers. RMSLTS, paras 3.39–3.43;
3. split purchase customers are in the same market as voice-only. RMSLTS, paras 3.44–3.53

On this basis, Ofcom concludes that the relevant market in this case is one that includes both voice-only and split purchase customers, which it terms ‘SFV’.²⁹ Ofcom then concludes that BT has SMP over this market on the basis of an analysis of market shares and BT’s profits for such customers.

In our view (and on the basis of our analysis in section 1), a perfectly reasonable and valid way for Ofcom to have defined the market would have been as a wider voice market including all of voice-only, split, and bundle customers, while recognising, if necessary, that different segments exist, based on preferences for broadband, willingness to pay, and levels of engagement in the market. This would be consistent with the approach adopted by the Competition and Markets Authority (CMA) in the context of market investigations conducted in the energy markets and by the FCA and the CMA for certain financial services products (see examples in section 2.1.3).

In such a broadly defined market, BT would not have SMP. This does not preclude the possibility that market outcomes cannot improve, but this is a different question, unrelated to an SMP finding, which would require a market-wide assessment and consideration of whether market trends will quickly render any concerns *de minimis*.

Ofcom has not taken such a view, and instead has chosen (incorrectly in our view) a more granular route to defining relevant markets. In this section we set out an economic assessment of the approach taken by Ofcom.

In section 2.1 we set out some of the general shortcomings of Ofcom’s approach, including the following.

- Ofcom’s approach to market definition does not provide an appropriate framework for assessing the issues that Ofcom has identified, and therefore weight cannot be placed on the provisional conclusions that Ofcom has reached. A broader market-wide framework would be a more appropriate approach.
- Ofcom misapplies the principles of price discrimination in conducting its analysis.

²⁹ Ofcom defines separate markets for access and calls, but this does not affect the analysis or findings of this report.

- In section 2.2 we present evidence that split purchase customers are in the same market as dual play customers and therefore Ofcom is incorrect in its SFV market definition.
- In section 2.3 we set out how Ofcom has overstated the concerns in relation to split purchase customers, given that many such customers are switching and appear to be already optimising across the services they consume.
- In section 2.4 we show that Ofcom has overlooked the competitive constraints that BT faces in respect of the voice-only customer segment resulting in an overstatement of the degree of market power that BT would have under Ofcom's (narrow) market definition.
- In section 2.5 we show the limitations of using an SMP approach in relation to the remedial action that can be used to address any concerns— this limitation is demonstrated by the fact that Ofcom's remedy proposals do not actually address its concerns, are disproportionate and will have unintended consequences:
 - Ofcom's proposed remedies for split purchasers do not address the cost of standalone broadband;
 - Ofcom has not addressed the impact of the proposed remedies on the migration to dual play bundles and digital inclusion.

2.1 Ofcom's approach has a number of shortcomings

According to Ofcom, the approach to market definition should keep in mind the end-goal of assessing the competitive constraints faced by firms and the necessity of regulatory interventions:

The market definition exercise is not an end in itself, but a means to assessing whether there is effective competition and thus whether there is a need for ex ante regulation.³⁰

There are, however, different approaches to market definition. We show below that a different approach would have given Ofcom a richer understanding of the market in question and a more appropriate framework for assessing any competition issues.

In particular, understanding SFV customers as segments of a wider market, rather than hypothesising artificially narrow markets, would enable Ofcom to more accurately assess the nature of competition and relevant interactions between segments (which are not properly captured by Ofcom), as well as the effects of any ex ante regulation (including potentially adverse effects).

Below we expand on a number of key flaws in Ofcom's approach. These can be summarised as follows:

- Ofcom's approach to market definition does not provide an appropriate framework for assessing the issues that it has identified—in particular, the level of market engagement by SFV customers;
- Ofcom overlooks the significant decline in the SFV market segment, which undermines the narrow-market SMP approach;

³⁰ Ofcom (2017), 'RMSLTS', para. 3.7, p. 15.

- markets do not need to be concretely defined in order for the regulator to comprehensively analyse the competitive constraints on different market players and how this delivers benefits to different customer segments;
- price discrimination between dual play customers and SFV customers is not necessarily proof of these two customer segments being in separate markets.

2.1.1 Ofcom's approach to market definition does not provide an appropriate framework for assessing the issues that Ofcom has identified

Ofcom's primary concern is the levels of engagement displayed by SFV customers:³¹

Survey evidence suggests that SFV customers have relatively low levels of engagement in the market (para. 4.8)

There are significant challenges in effectively communicating with consumers who are not actively engaged in the market. (para. 1.25)

[...] which limit the ability of other communications providers (CPs) to compete effectively and expand in the market (para. 7.3)

Our aim in imposing [...] measures is to allow other providers to compete more vigorously in this market and to win customers. If the engagement remedies we are proposing are effective, we would expect consumers to benefit in terms of price and choice (para. 1.26)

As we have explained in further detail in section 1 above, to the extent that this is an issue, it is a problem that affects not only BT customers but all consumers; in short, it is a market-wide issue.

Ofcom's approach erroneously labels this market-wide issue as an SMP issue, and one applicable only to BT.

2.1.2 Ofcom gives insufficient weight to key factors relevant to market definition

As also explained in section 1, Ofcom has overlooked the significant decline in the SFV market segment, and implies that the remaining customers are more inert than those who have moved to dual play bundles.³² However, the SFV market will decline significantly over the coming years, as explained in section 1.3.

A claim that the remaining SFV customers would not continue to switch would necessarily imply that there is a change in the nature of the customers. That is, current SFV customers are less engaged than those who have already switched to dual play bundles. However, it is not clear from Ofcom's analysis that this is the case, and there is no reason to believe that the rate of decline of the SFV base will materially slow down going forward. Indeed, only 5% of SFV customers state that they do not want or need broadband.³³

³¹ See Ofcom (2017), 'BT's landline-only customers set for cheaper bills', press release, 28 February, which states as one of the headline bullet points that 'Landline-only customers are often elderly or vulnerable, unlikely to switch'.

³² Ofcom (2017), 'RMSLTS', para. 3.41.3, p. 24.

³³ Jigsaw (2016), 'Narrowband Review 2016', November, Figure 15, p. 22.

2.1.3 A broader market framework would provide a richer understanding of the competitive dynamics and how to address any alleged concerns

While it may be legitimate to investigate levels of customer engagement, this has nothing to do with the behaviour of an individual firm (or indeed a collection of firms).

Any such assessment would start from the view of a broad market and would consider whether less-engaged customer segments are benefiting as much from the highly competitive retail voice market as groups who are more engaged.

Boxes 2.1 and 2.2 detail two recent examples of where the CMA has analysed markets including customer engagement issues on a market-wide basis, without the need to define narrow markets including the customer groups of concern or to identify SMP (individually or collectively).

The key messages of these case studies are:

- markets do not need to be concretely defined for the regulator to comprehensively analyse the competitive constraints on different market players and within the particular market segments;
 - a market-wide assessment (as opposed to the SMP framework) enables the application of more effective and flexible (market-wide) remedies, which can better address concerns around customer engagement. (For example, disengaged customers with the Post Office and other providers such as KCom would not be addressed under Ofcom's SMP analytical framework.)
-

Box 2.1 CMA energy market investigation

Consider the recent example of the 2016 CMA investigation into the energy market.³⁴ While it did consider different aspects to market definition, the CMA preferred to view the energy market as a broad market with different market segments. Some of these market segments had lower levels of customer engagement and remedies were targeted at these groups. The CMA did not use the SSNIP test to show narrow markets, and did not conclude on SMP. This is a more suitable approach when considering differing levels of customer engagement in a broad market.

The CMA's summarises its approach as:

Defining the market provides a framework for the assessment of the effects on competition of features of a market. Market definition is a useful tool, but not an end in itself, and we note that the boundaries of the market do not determine the outcome of our competitive assessment in any mechanistic way. Notably, in some cases, where we consider that competitive pressures differ between different types of customer, we identify discrete customer segments within markets.³⁵

Therefore it concluded that, while certain groups of identifiable customers were less engaged (those on standard variable tariffs, SVT) and while there was evidence of price discrimination:

customers do not fall into discrete camps of 'engaged' and 'disengaged'. There is a variety of degrees of engagement, and some domestic customers are relatively active before defaulting to an SVT. We therefore did not think that customers subscribing to SVT and non-standard tariffs were sufficiently distinct to warrant defining separate markets for them.

Accordingly, our conclusion is that customers subscribing to an SVT and those subscribing to non-standard tariffs fall into different market segments of the domestic retail markets, in the light of the different intensity of competition to which they are subject.³⁶

This approach gave the CMA more flexibility in understanding the market dynamics and enabled it to target remedies at all SVT customers.

Thus Ofcom's SMP approach has limited Ofcom's flexibility regarding remedy options. The remedy options left available to Ofcom are disproportionate and fail to deal with the market-wide issue.

Source: Oxera.

³⁴ Competition and Markets Authority (2016), 'Energy market investigation', Final report, 24 June. <https://assets.publishing.service.gov.uk/media/5773de34e5274a0da3000113/final-report-energy-market-investigation.pdf> accessed 8 May 2017.

³⁵ Ibid., para. 27.

³⁶ Ibid., paras 3.33–3.34.

Box 2.2 CMA retail banking market investigation

Another example is the 2016 retail banking market investigation by the CMA.³⁷ Here the CMA identified one broad market, without defining separate markets for different types of personal current account. The CMA's starting point was as follows:

The guidelines also state that, in some cases, the CMA may treat a group of product, geographic or other types of markets together for the purposes of assessing competitive effects. This can be the case where a feature manifests itself in a similar way across several different markets (for example, the need for an operating licence may be an aspect of many local markets) and the CMA is able to reach a view about the effects of the feature on competition across the group of markets as a whole. Thus we are not required to identify the narrowest possible market(s).³⁸

The CMA found that different customer segments paid different prices,³⁹ and that some customer segments were making more of a contribution to common costs than other segments (although all segments were covering incremental costs).⁴⁰ Notably, some of the banking providers submitted to the CMA that they were able to identify customers according to whether they were active or inactive, and therefore could price-discriminate between customer segments.⁴¹ The CMA agreed that price discrimination was occurring, although with some limitations.⁴²

Despite finding varying degrees of customer engagement and the presence of price discrimination, the CMA did not identify narrow markets and was able to target remedies at customer segments that raised the most concern. The CMA was able to make the remedies market-wide (with a de minimis threshold).

Source: Oxera.

Box 2.3 discusses the payment protection market investigation by the Competition Commission, and illustrates that disengaged customers are usually a market-wide problem.

Box 2.3 Competition Commission investigation into payment protection insurance

A 2009 investigation into payment protection insurance (PPI) found that consumer engagement was so low for the purchase of PPI that all suppliers had market power over their own customers. This was because PPI was an add-on (a secondary market) and thus consumers tended not to shop around when deciding whether to purchase it.

Thus the problem of disengaged customers was identified as a market-wide issue: PPI providers had market power over their customers (as the customers were not shopping around). Specifically, the Competition Commission found barriers to consumer searching, including: the time-consuming nature of obtaining quotes; difficulty in making comparisons between providers; complexity of the products on offer; and misperceptions of the benefits of the products. The Commission also found barriers to switching, poor consumer awareness of PPI products and that the high marketing costs associated with attracting PPI customers acted as a barrier to entry.⁴³

Therefore the remedies were also market-wide, rather than imposed only on the larger PPI providers. This ensured that no disengaged customers were ignored.

Source: Oxera.

³⁷ Competition and Markets Authority (2016), 'Retail banking market investigation', Final report, 9 August. <https://assets.publishing.service.gov.uk/media/57ac9667e5274a0f6c00007a/retail-banking-market-investigation-full-final-report.pdf>, accessed 8 May 2017.

³⁸ Ibid., para. 4.7.

³⁹ Ibid., para. 5.73.

⁴⁰ Ibid., para. 9.135(d).

⁴¹ Ibid., para. 10.24.

⁴² Ibid., para. 10.51.

⁴³ Ibid., para. 3.139.

2.1.4 Ofcom misapplies the principles of price discrimination

This section shows that price discrimination between dual play customers and SFV customers is not necessarily proof of these two customer segments being in separate markets.

Price discrimination is a practice in many markets, as is the presence of consumers with heterogeneous preferences. Price discrimination is neither a necessary nor sufficient condition for the definition of a separate market. Accordingly, the 2013 Competition Commission Market Investigation Guidelines state that:

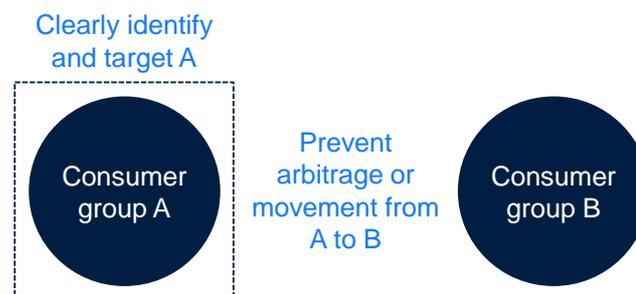
Many markets serve a diverse customer base, for example suppliers may have both business and personal customers. One set of customers may be more affected than others by any particular feature. Where such diversity exists, and where suppliers can charge different prices to different groups (ie price discriminate), the CC will recognize these differences. In terms of market definition, depending on the market and the evidence presented, the CC may choose either to treat these different groups as separate markets, or as segments within one market, noting the scope for price discrimination between different groups within the market⁴⁴

Price discrimination could be used to define separate markets if a hypothetical monopolist could impose a SSNIP on a consumer group (rather than the whole market). That is, if the hypothetical monopolist could use price discrimination to segment markets. As shown by Hausman, Leonard and Velturo (1996),⁴⁵ price discrimination⁴⁶ can occur only when certain conditions are met:

- different groups of consumers have different elasticities of demand;
- the different consumer groups can be accurately identified and targeted by the hypothetical monopolist. Even small amounts of uncertainty in identifying consumer groups can preclude profitable price discrimination;
- profitable arbitrage of the product between the consumer groups is not possible.

This is illustrated in Figure 2.1. Here consumers groups A and B may be separate markets.

Figure 2.1 Price discrimination as segmentation strategy



Source: Oxera.

⁴⁴ Competition Commission (2013), 'Guidelines for market investigations: Their role, procedures, assessment and remedies', CC3 (Revised), April, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/284390/cc3_revised.pdf, accessed 8 May 2017.

⁴⁵ Hausman, J. A., Leonard, G. K. and Velturo, C. A. (1996), 'Market definition under price discrimination', *Antitrust Law Journal*, 64.

⁴⁶ Specifically, third degree price discrimination.

However, in the case at hand which is the focus of Ofcom's market review, the third condition does not hold: customers are encouraged to arbitrage.

Price discrimination as a migration strategy, not a segmentation strategy

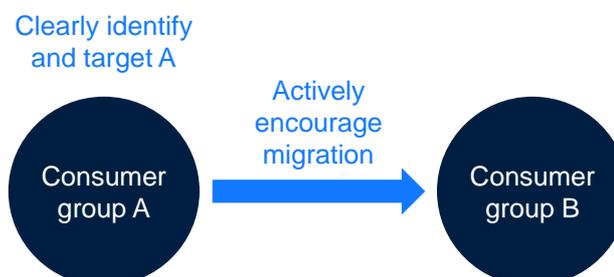
A core assumption of Hausman et al. (1996) is that the hypothetical monopolist finds it profitable to separate the consumers and keep the groups apart. In the case of the landline market, it is the express strategy of the CPs to migrate customers from one customer group to the other (SFV to dual play). Price discrimination is a migration strategy, not a market segmentation strategy.

Indeed, Ofcom acknowledges that the migration strategy is consistent with the evidence:

Offering competitive dual-play prices alongside line rental price increases may be a more effective way for SFV suppliers (or a hypothetical monopolist in SFV) to compete for voice-only customers who are considering buying fixed broadband as well, compared to keeping line rental prices lower. This would be consistent with the historical pattern of price changes.⁴⁷

The use of price discrimination to migrate customers is a qualitatively different strategy to that of market segmentation. Under a market segmentation strategy the hypothetical monopolist would actively try to prevent arbitrage between the consumer groups. Under a migration strategy, the arbitrage opportunity is highlighted to consumers to encourage switching—indeed, the creation of the arbitrage opportunity is the very *purpose* of the price discrimination. This is shown in Figure 2.2.

Figure 2.2 Price discrimination as migration strategy



Source: Oxera.

Additionally, the inability to prevent arbitrage means that Ofcom's proposed price cut could have a detrimental effect on the migration to bundles—dual play customers would have the incentive and ability to 'unbundle' and return to split purchases if their valuation for broadband no longer exceeds the implicit incremental broadband price which is increased as a result of the price control.

In summary, Ofcom correctly identifies that price discrimination is ongoing between SFV customers and dual play customers. However, a careful analysis of this pricing strategy reveals that it is evidence of a broad market, rather than separate narrow markets.

2.2 Split purchase customers should be in the same market as dual play

In this section we set out why split purchase customers are in the same market as dual play customers. This is on the basis of the following:

⁴⁷ Ofcom (2017), 'RMSLTS', para. 3.36.5, p. 22.

- split purchaser and dual play customers consume functionally equivalent services;
- split purchaser and dual play customers have very similar characteristics in terms of demographics, engagement levels and switching activity,

We set each of these out in more detail below.

2.2.1 Split purchaser and dual play customers consume functionally equivalent services

Split purchase customers are by definition purchasing landline and fixed broadband services. In other words, the products consumed are functionally equivalent to those consumed by dual play customers. This means that:

- CPs are able to offer broadband on the basis of split purchase or dual play;
- split purchase customers can switch to dual play bundles without losing either of the services they consume. Similarly, dual play customers might wish to switch back and unbundle (although the strategy of price discrimination is aimed at preventing this, see above).⁴⁸

From the perspective of consumers wishing to have broadband, they do not experience any service difference from a split or dual play service. The quality of the service will be alike.

2.2.2 Split purchase customers and dual play customers have very similar consumer characteristics

Ofcom's research highlights that split purchase customers and dual play customers are very similar in terms of a number of key features, such as:

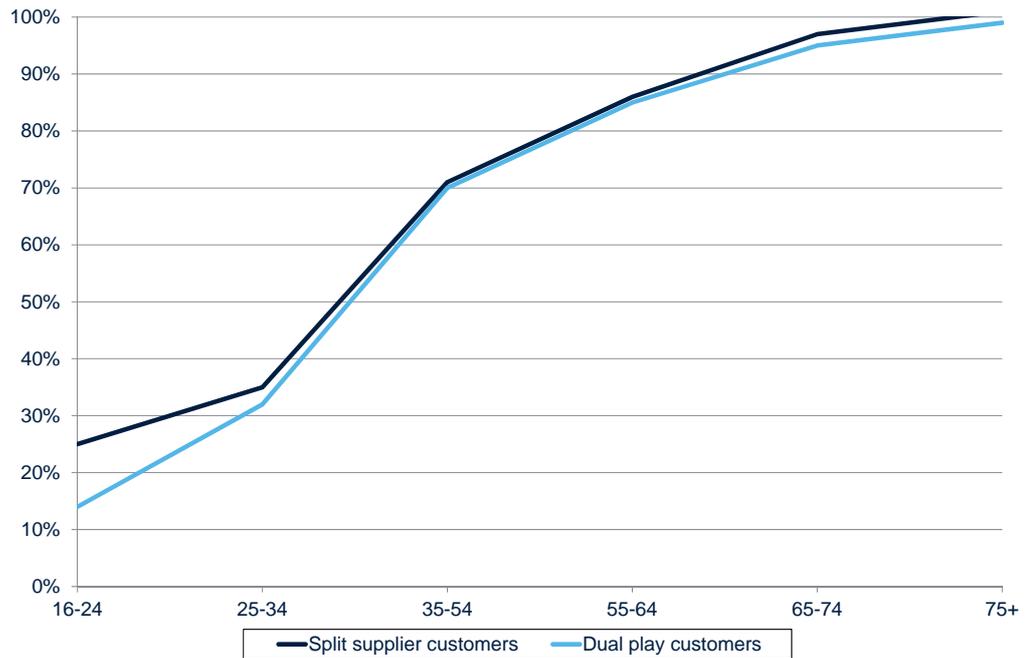
- demographics;
- engagement levels and switching activity;
- mobile usage and degree of substitutability.

Demographics

Using Ofcom's own analysis, we can see that split purchase customers have very similar demographics to those of dual play customers. First, split purchase customers have a very similar age distribution to dual play customers (see Figure 2.3). The most significant difference between the segments is that there are more split purchase customers in the youngest category (16–24-year olds).

⁴⁸ While a particular CP may disallow its consumers from unbundling its dual play services (i.e. becoming a split service customer), it would not be able to stop a customer using another CP's standalone products (i.e. becoming a split provider customer).

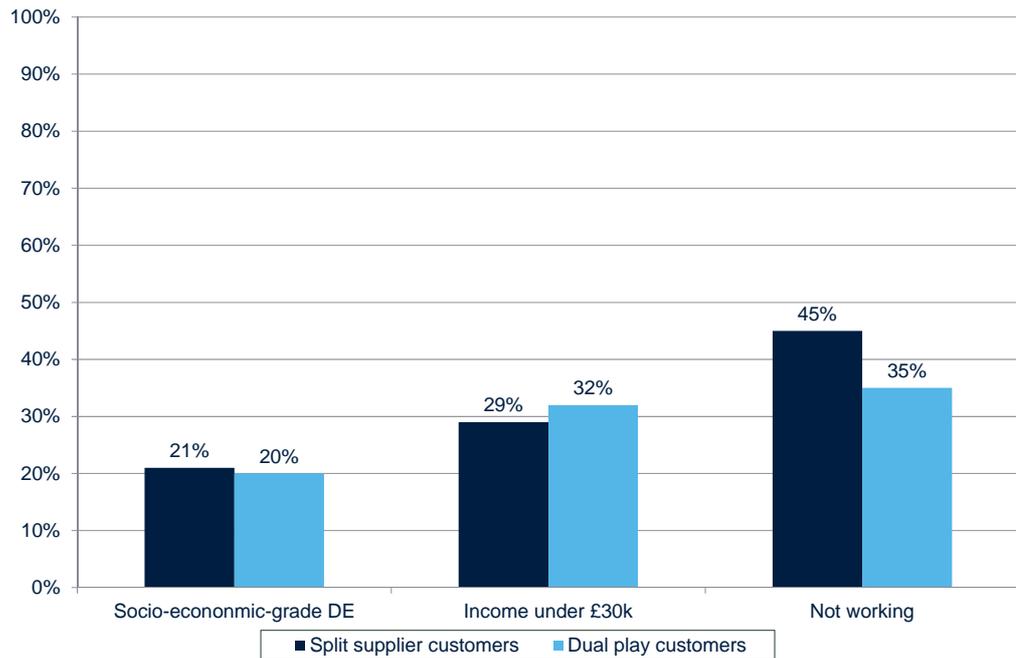
Figure 2.3 Cumulative age distribution of landline customers



Note: The total does not sum to 100% due to rounding. Split purchase supplier data collected by Jigsaw survey rather than split purchaser, but this should be representative of the split purchaser consumer group—see Ofcom (2017), ‘RMSLTS’, Annex Footnote 191. Split supplier customers purchase their standalone voice from one provider and standalone fixed broadband from another provider.

Source: Ofcom (2017), ‘RMSLTS’, Table A8.49.

Second, split purchase customers have very similar socio-economic distribution to dual play customers, with a similar level of income and a similar proportion in work. As shown in Figure 2.4, the proportion of customers who are in the lowest socio-economic grades DE is almost identical for split purchaser and dual play customers, as is the proportion who earn less than £30,000 per year. The proportion who are working is broadly similar, although lower for split purchaser customers.

Figure 2.4 Proportion of landline customers who are less wealthy

Note: Split supplier data collected by Jigsaw survey rather than split purchaser, but this should be representative of the split purchaser consumer group—see Ofcom (2017), ‘RMSLTS’, Annex Footnote 191.

Source: Ofcom (2017), ‘RMSLTS’, Tables A8.49 and A8.50.

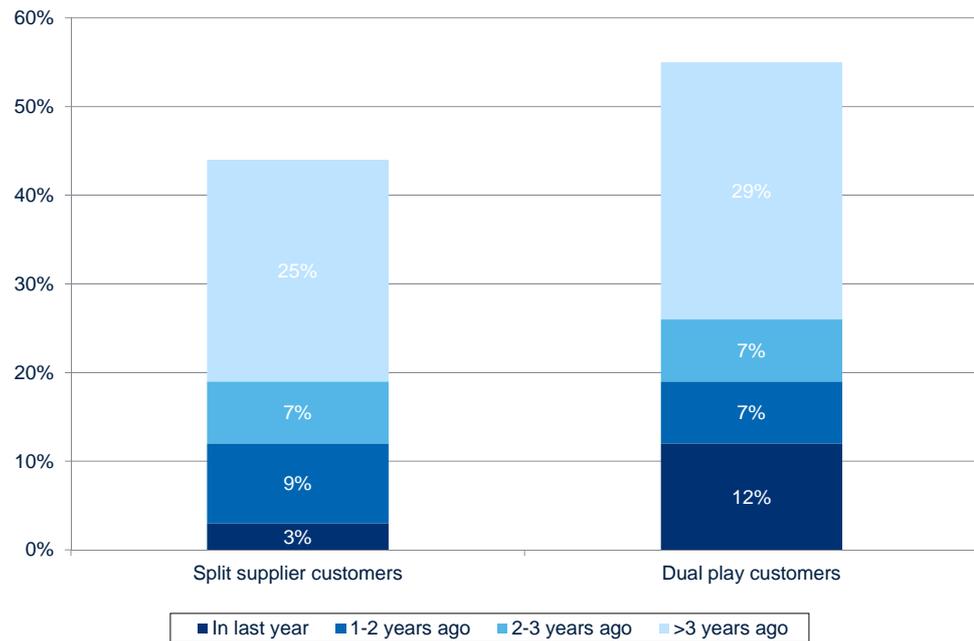
Engagement levels and switching activity

Split purchase customers and dual play customers also show similar levels of engagement and switching activity. We present Ofcom’s analysis in Figure 2.7, noting that the levels of switching are broadly similar—26% of dual play customers have switched in the past 3 years; for split purchase customers this is 19%.

First, according to Ofcom’s research, significant numbers of split purchase customers have switched supplier, although the switching rate is stated as lower than that of dual play customers. We present this data in Figure 2.5 below. This, however, misses a key point. A significant proportion of split purchaser customers have already switched to dual play bundles over the last few years. The statistics will therefore display such (previously split purchase) consumers as now consuming dual play bundles. The switching of these formerly split purchase customers to dual play will appear in the chart as switching undertaken by current dual play customers.

The statistics shown in Figure 2.5 therefore underestimate the level of switching among split purchase customers. However even on the basis of the figures, we note that split purchase customers do exhibit a material amount of switching—almost 20% have switched in the last 3 years, compared with 26% for dual play customers.

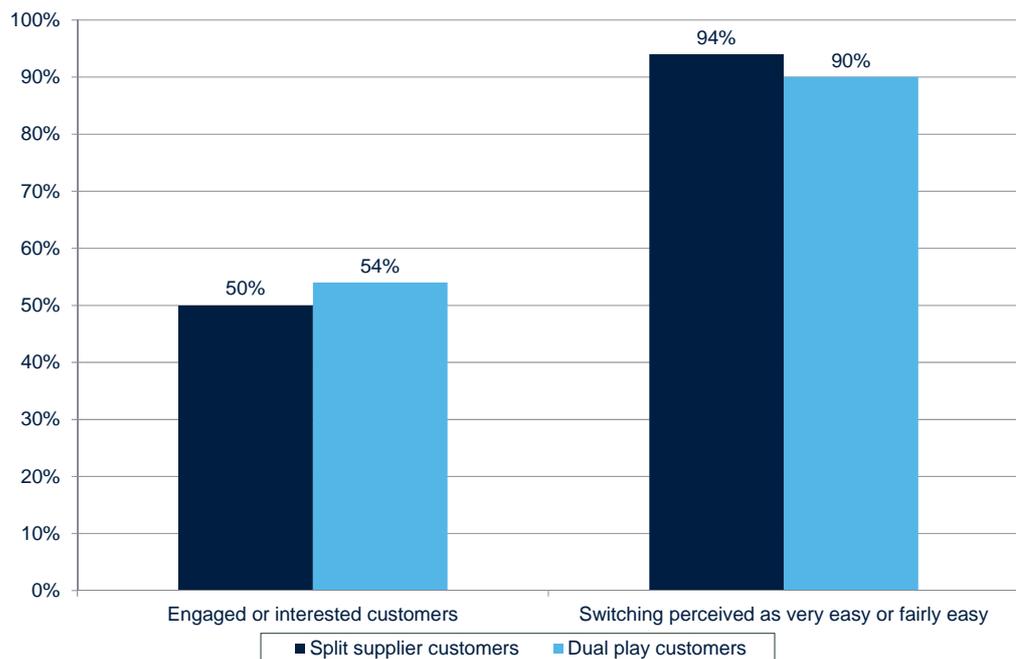
Figure 2.5 The proportion of customers who have switched landline provider



Note: Split supplier data collected by Jigsaw survey rather than split purchaser, but this should be representative of the split purchaser consumer group—see Ofcom (2017), ‘RMSLTS@ Annex Footnote 191.

Source: Ofcom (2017), ‘RMSLTS’, Table A8.57.

Second, self-reported levels of engagement are similar across dual play and split purchase customers, as is the perceived ease of switching. This is shown in Figure 2.6 below.

Figure 2.6 Engagement levels and perceptions of switching

Note: Split supplier data collected by Jigsaw survey rather than split purchaser, but this should be representative of the split purchaser consumer group—see Ofcom (2017), 'RMSLTS', Annex Footnote 191.

Source: Ofcom (2017), 'RMSLTS', Table A8.51 and Table A8.60.

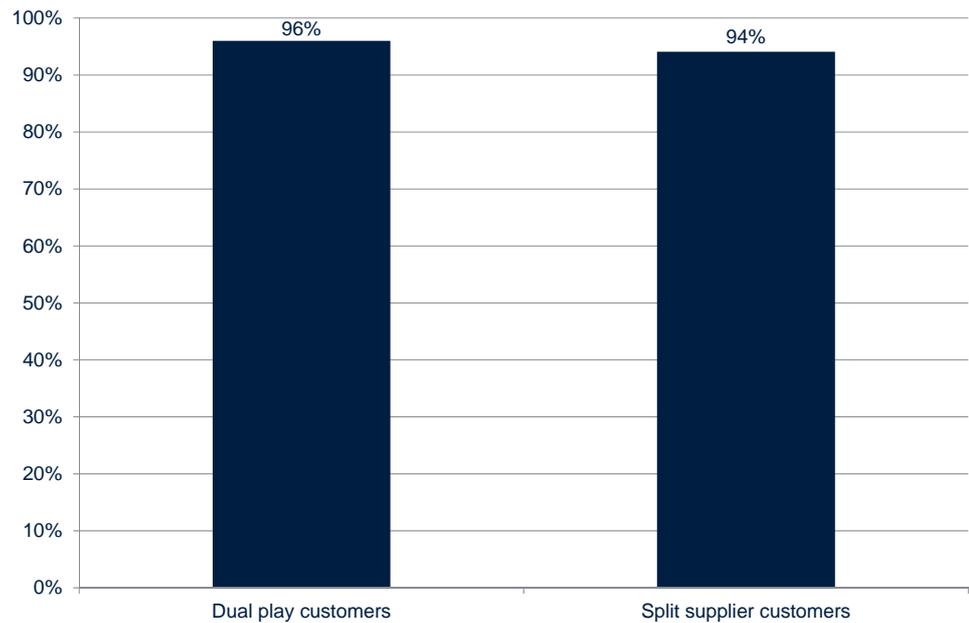
In summary switching activity or levels of engagement are broadly comparable between split purchaser and dual play customers. This further supports the view that both groups of customers should be considered as part of the same market.

Mobile usage and degree of substitutability

Mobile services place a competitive constraint on the providers of fixed landline services. Indeed, the proportion of split purchase customers who own a mobile phone is nearing saturation.

The data (presented in Figure 2.7) shows that when compared with dual play customers, a very similar proportion of split purchase customers have a mobile phone. We also note that the majority of split purchase customers have smartphones (71%).⁴⁹

⁴⁹ Jigsaw market research for Ofcom Narrowband Review 2016, residential survey (wave 1) table 906 (pp. 1443).

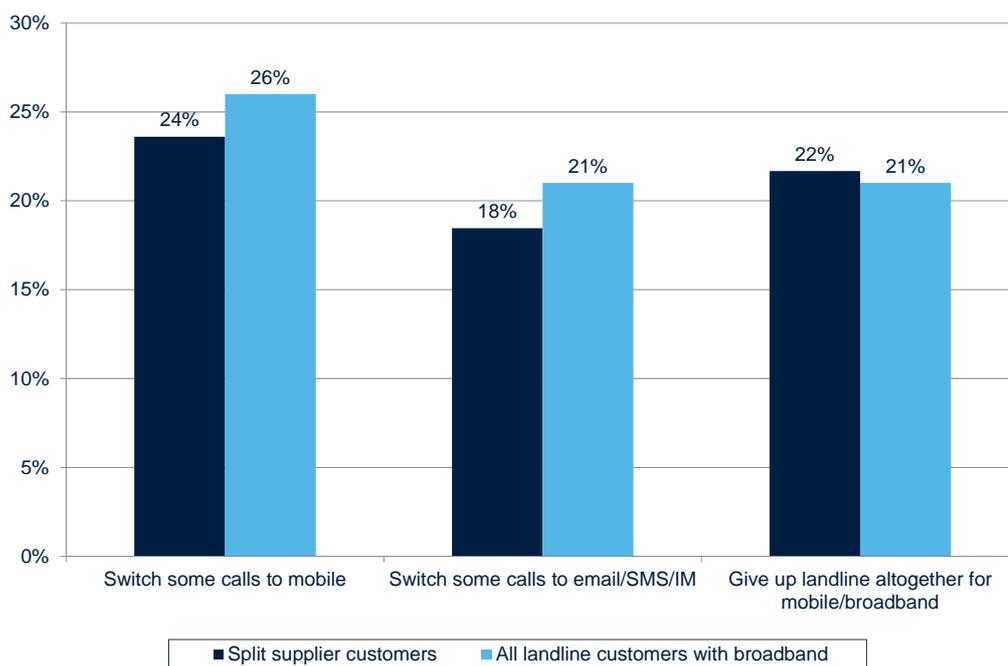
Figure 2.7 Proportion of customers who own a mobile phone

Note: Split supplier data collected by Jigsaw survey rather than split purchaser, but this should be representative of the split purchaser consumer group—see Ofcom (2017), 'RMSLTS', Annex Footnote 191.

Source: Jigsaw market research for Ofcom Narrowband Review 2016, residential survey (wave 1), table 908 (p. 1485); and Ofcom (2017), 'RMSLTS', para. A8.149.

Additionally, very similar proportions of dual play customers and split purchase customers would respond to a SSNIP on their landline bill by switching some or all of their calls to mobile services (see Figure 2.8 below).

Figure 2.8 If overall landline bill price increases by 10%, what proportion of customers would be likely to...



Note: Split supplier data collected by Jigsaw survey rather than split purchaser, but this should be representative of the split purchaser consumer group—see Ofcom (2017), ‘RMSLTS’, Annex Footnote 191. ‘SMS’: text messaging; ‘IM’ instant messaging.

Source: Jigsaw market research for Ofcom Narrowband Review 2016, residential survey (wave 1) data tables, tables 633 (p. 1011), 661 (p. 1048), and 908 (p. 1485).

In light of the above, there is convincing evidence that split purchase customers are similar to dual play in terms of demographics, propensity to switch product/provider, level of engagement, and their propensity to switch to mobile services.

2.3 Ofcom overstates the concerns for split purchase customers

In this section we set out how (at least a proportion of) split purchase customers are engaging with offers in the market and are making reasoned choices. Ofcom appears to reach a view that, in general, split purchase customers are not getting a good deal; however it provides little evidence that this is the case, and implies that all split purchase customers would be better off moving to dual play.

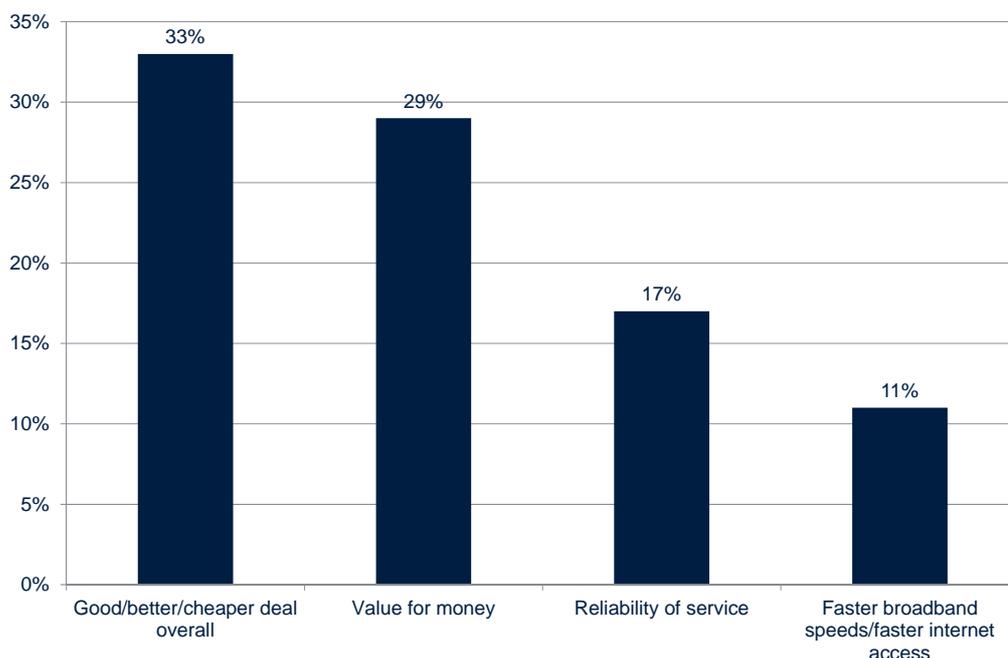
We show below that the savings available to some split purchasers may be small, leading to the conclusion that split purchasers may be optimising their purchases already (in the presence of rational switching costs). This is supported by Ofcom’s survey evidence.

2.3.1 Survey evidence supports the conclusion that some split purchasers are already optimising

Ofcom’s survey evidence points to the fact that many split purchase customers are already optimising.

As shown in Figure 2.9, consumers set out a number of reasons why they chose not to buy broadband from the same CP as that providing their landline. This insight shows that a significant proportion of split purchase customers are making rational decisions.

Figure 2.9 Why do split purchasers purchase broadband and landline from different companies?



Source: Jigsaw market research for Ofcom Narrowband Review 2016, residential survey (wave 1) data table 106, p. 226.

This is good evidence to support the view that some split purchase customers are already optimising [their service]—i.e. have found the best deal for them.

As the above figure indicates, this optimisation is likely to capture both price and non-price factors (reliability and speed of service), and indicates that some split purchase customers are making informed choices.⁵⁰

2.3.2 Rational switching costs may outweigh small savings

In this section we set out why consumers not switching may be a rational choice.⁵¹ This is because, in any normal market, there can be frictions that are not caused by customers behaving sub-optimally. Such frictions could include switching costs, which are present in all markets, and could explain why consumers do not switch provider when the savings are small. Examples of such costs include:

- the time cost of finding and sorting a new contract—calling a new provider to discuss offerings, and calling the old provider to cancel the existing contract;
- fear of service decline—risk-averse customers may not wish to switch for fear of a reduction in service quality, or a perception of installation issues during the CP handover; and,
- the time cost of an engineer visit—this typically involves waiting at home for the installation to be completed by an engineer. Again, the consumer may

⁵⁰ Split purchase customers may be optimising their service by choosing the best service/provider in respect of each component: fixed voice and broadband. For example, if a consumer wants within their fixed call service, Nuisance Call Protect, faster repair on their line and unlimited free weekend calls (including 0845 and 0870), they might choose BT for the line rental. They may then look for the broadband offering that best meets their needs (taking into account quality and price factors), which may not be from the same provider as their landline.

⁵¹ There are models of rational inattention. For example, see Sims, C.A. (2003), 'Implications of rational inattention', *Journal of Monetary Economics*, 50.

value their time highly and, in full knowledge of the small savings from switching, choose not to switch.

When combined, such costs may deter consumers from switching to a lower cost service, unless the savings they would make were very significant. Ofcom appears to overlook these switching costs in its assessment. For example, if the available savings from switching were £1 per month (which Ofcom suggests will be the case for some split purchase migrations), a rational consumer with a time horizon of one year would make the effort to switch only if they valued the lost time and expended effort at under £12. However, it is entirely plausible that a rational consumer would not switch under these circumstances—i.e. the £12 annual saving is not sufficient to offset the inconvenience of switching.

In short, some switching friction should be anticipated, and we would not expect all customers to migrate immediately to another CP offering the same service at a lower price. Furthermore, some consumers may be optimising their service already.

2.3.3 Ofcom may be overstating the savings from switching to dual play bundles

In the Annexes to the consultation document Ofcom shows that some split purchase consumers face small gains from switching to dual play bundles.⁵² For example:

- a BT customer consuming 52MB/Unlimited would enjoy savings of £0.08 per month if they switched to a standard price dual play bundle;
- a BT customer consuming 76MB/Unlimited would enjoy savings of £1.26 per month if they switched to a standard price dual play bundle;
- a Sky customer consuming 17MB/Unlimited would enjoy savings of £3 per month if they switched to a standard price dual play bundle;
- a Sky customer consuming 38MB/Unlimited would enjoy zero savings if they switched to a standard price dual play bundle.

These savings are small, if they exist at all. However, Ofcom still calculates the weighted average saving as £8.01 per month. There are aspects of Ofcom's methodology that lead to the impression of higher savings than consumers would actually be able to achieve. For example:

- **omitting lower line rental prices:** some split purchase customers receive their line rental from CPs other than BT. The use of BT's line rental (£18.99) overstates the cost of line rental for many split purchasers. For example, those taking line rental from the Post Office may be paying only £15 per month for their line rental).⁵³
- **omitted providers, such as Plusnet and SSE:** some split purchase customers will be with providers, such as Plusnet, which offer standalone broadband from £13.49 per month which is cheaper than the BT weighted average deals shown by Ofcom.⁵⁴ If a customer purchased Plusnet

⁵² Ofcom (2017), 'RMSLTS', Annexes Figure A8.43.

⁵³ Ofcom (2017), 'RMSLTS', Annexes Figure A8.24; and the Post Office website <http://www.postoffice.co.uk/broadband-phone>, accessed 8 May 2017.

⁵⁴ <https://www.plus.net/home-broadband/broadband-only/> <https://www.plus.net/home-broadband/>, accessed 8 May 2017.

standalone broadband and the BT line rental, the savings from switching to a dual play bundle of the same speed would be small;

- **omitted deals from legacy customers:** some standalone broadband customers will come from legacy operators including Tesco, Tiscali and O2. These brands may have advertised low standalone broadband, which may mean some split purchase customers are on low-cost deals.

Together, these mean that the estimated savings available to the split purchase consumers from switching to dual play bundles are overstated. In light of these smaller savings, it may be that some consumers are already optimising by not switching.

2.4 Ofcom appears to underestimate the constraints BT faces in respect of voice-only customers

Ofcom appears to overlook the fact that BT faces material competitive constraints in the voice-only customer segment. Notably:

- the Post Office is actively looking to secure voice-only customers
- mobile provides a constraint on landline services including voice-only customers
- many voice-only customers have access to broadband, and therefore are able to assess market offers

These three factors are explored below.

2.4.1 The Post Office is actively looking to secure voice-only customers

The Post Office is an active competitive constraint on BT in the voice-only customer segment. The Post Office's overall SFV market share has been increasing since 2012 and is in the range of 5–15%.⁵⁵ The Post Office also has 5–15% market share of the voice-only customer segment.⁵⁶

The Post Office has a strong strategy to attract new voice-only customers, which is detailed in the Ofcom consultation document.⁵⁷ This strategy has involved having the cheapest line rental price (since 2011)⁵⁸ and:

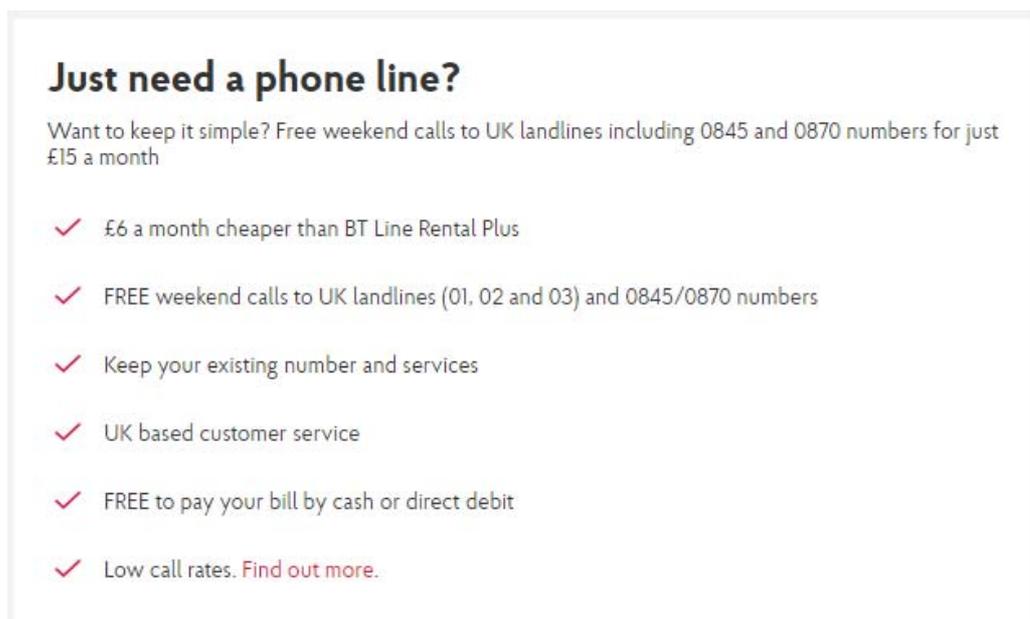
- three acquisition channels (online, call centre and in-branch);
- various marketing campaigns which highlight the ease of switching;
- an introductory offer of lower prices (12 months at £14.99 per month—£6 per month cheaper than BT).

⁵⁵ Ofcom (2017), 'RMSLTS', para. 4.18.

⁵⁶ Ibid., para. A8.39.

⁵⁷ Ibid., para. A8.56.

⁵⁸ Ibid., Figure A8.24.

Figure 2.10 Post Office advertising landline services

Just need a phone line?

Want to keep it simple? Free weekend calls to UK landlines including 0845 and 0870 numbers for just £15 a month

- ✓ £6 a month cheaper than BT Line Rental Plus
- ✓ FREE weekend calls to UK landlines (01, 02 and 03) and 0845/0870 numbers
- ✓ Keep your existing number and services
- ✓ UK based customer service
- ✓ FREE to pay your bill by cash or direct debit
- ✓ Low call rates. [Find out more.](#)

Source: Post Office Website, accessed 3 May 2017.

In summary, the Post Office is an active competitive constraint on BT in the voice-only market segment.

2.4.2 Ofcom does not appear to fully account for the constraint mobile has on fixed voice services

Mobile services are an active competitive constraint on providers of fixed voice services. The evidence for this includes the following.

- Ofcom claims that over half (58%) of voice-only customers own a mobile phone.⁵⁹ Other evidence suggests that this proportion could be even higher—for example, the Jigsaw wave 1 survey finds that 69% of those with a landline but no broadband own a mobile phone.⁶⁰
- If the overall landline price increased by 10%, a significant proportion of voice-only customers would switch to mobile services.⁶¹ Specifically, 11% of voice-only customers would be likely to switch some calls to mobile; 8% would be likely to switch some calls to email/text messages/instant messages; and 10% would be likely to give up their landline altogether

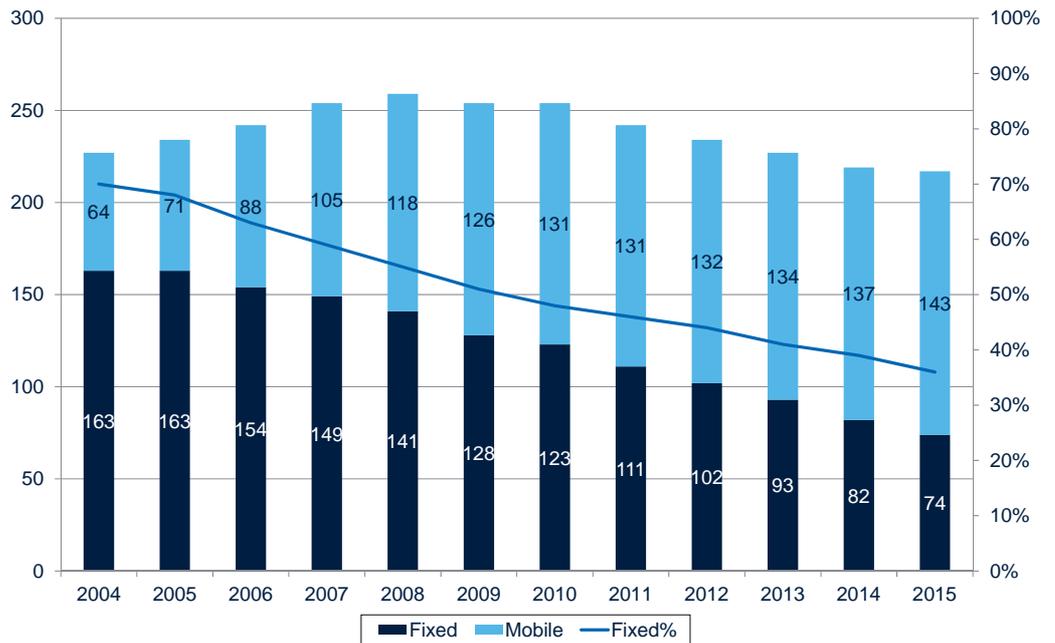
Thus, in light of ongoing fixed to mobile substitution in the voice market, mobile is likely to provide a material competitive constraint to the pricing on landline services. See, for example, Figure 2.11.

⁵⁹ Ofcom (2017), 'RMSLTS', para. 3.58.

⁶⁰ Jigsaw survey wave 1, Table 906 (p. 1439).

⁶¹ Jigsaw survey wave 1, tables 639, p.1011, 661, p.1048, and 672, p.1065. It is not clear from the survey whether these percentages can be summed together, or whether they represent the same customers.

Figure 2.11 Decline in fixed call volumes (billions of minutes)

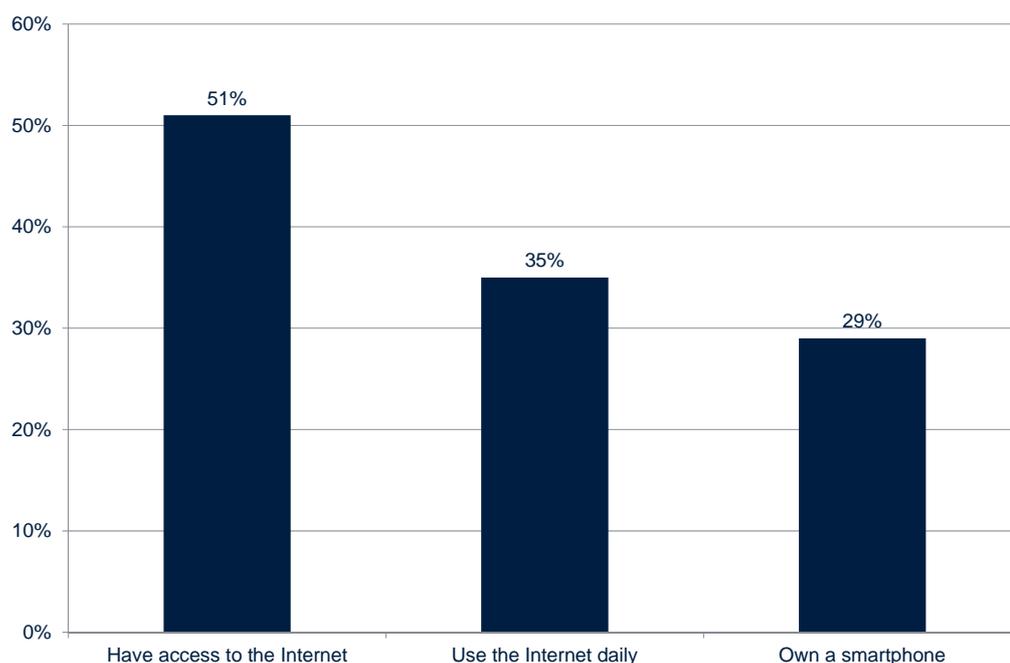


Source: Ofcom (2016), 'Narrowband Market Review', consultation, 1 December, Figure 1.1, p. 4.

2.4.3 Many voice-only customers have access to the Internet despite not having a fixed broadband service themselves

Ofcom overlooks the fact that many voice-only customers have access to broadband (for example by using their friends'/family's Internet connection, free Internet in local libraries, or mobile data/broadband) and are therefore able to search for better landline offers.

Figure 2.12 shows that just over half of voice-only customers have access to the Internet and over a third use it daily. Also, 29% of voice-only customers own a smartphone.

Figure 2.12 Voice-only customers have access to the Internet

Source: Jigsaw market research for Ofcom Narrowband Review 2016, residential survey (wave 1). Data table 906 (p.1441, 1443).

As seen in the figure, many voice-only customers have internet access and are active online. Indeed, the Post Office acquires 20% of its voice-only customers through online channels.⁶² This means that many voice-only customers would be able to access market information,⁶³ such as price comparison websites which are an important source of information.⁶⁴ The barriers to consumer engagement in the voice-only segment are less than Ofcom assumes.

2.4.4 CPs do have an interest in competing for standalone voice customers

We note that there are still significant gains to be made from the voice-only segment, which provide an incentive for CPs to enter, or compete more strongly in, the voice-only segment. Ofcom states that:

The data suggests that some other CPs are making reasonably high profits from their fixed voice customers, though none as high as BT.⁶⁵

Ofcom assumes that CPs would have to offer a 25% discount on line rental compared with BT in order to win customers, but that the CPs would still be making a 'significant and positive' marginal profit per consumer.⁶⁶

Therefore Ofcom assumes that the marginal SFV customer currently generates at least £4.74 per customer (with line rental of £18.99).⁶⁷ If a CP competed in the voice-only market and gained a 10% market share, the CP would have approximately 170,000 customers.⁶⁸ With line rental of £18.99 and market share

⁶² Ofcom (2017), 'RMSLTS', para. A8.56.

⁶³ With regard to the access/assess/act framework.

⁶⁴ Ofcom (2017), 'RMSLTS', para. A6.5.5.

⁶⁵ Ofcom (2017), 'RMSLTS', para. A5.71.

⁶⁶ Ofcom (2017), 'RMSLTS', Table A5.12

⁶⁷ Ten percent of £18.99 minus £5 is £1.40.

⁶⁸ Total segment size of approximately 1.7 million. Ofcom (2017), 'RMSLTS', Figure A8.8.

of 10%, this would therefore generate profits of at least £807,075 per annum. Indeed, the Post Office currently offers line rental for £15, a price that is profitable according to this analysis.⁶⁹

This is demonstrated by the efforts currently being made by the Post Office, as set out in more detail in section 2.4.1.

2.4.5 It is not clear that BT is a price leader for voice-only

As a result of being found to have SMP for the provision of wholesale local access services, BT is regulated and required to provide at cost (and in a non-discriminatory way) wholesale access to landline phone and standard broadband (MPF and WLR+SMPF). Currently, the regulated wholesale charge is around £8 per calendar month for WLR.

As such, retail service providers can purchase a wholesale input and compete at the retail level for the provision of fixed voice services. Given this, there is a level playing field, which creates a platform for competition to play out downstream, and for firms to compete for customers.

As a wholesale provider, BT has no control over the retail prices set by its downstream competitors.

Despite this, Ofcom argues that prices have converged as a result of price increases and, in particular, that other CPs have followed price changes implemented by BT over the period April 2014 to January 2017 (RMSLTS, para. 4.52).

We do not consider that this provides any reliable evidence of BT playing a price leadership role for a number of reasons.

- The period is too short to make any meaningful inferences. As noted by Ofcom, CPs appear to be updating their prices on an annual basis (para A8.63). As a result, the period considered by Ofcom (2014–17) contains a sample of only three price adjustments (Figures A8.26–A8.28).
- What might appear to be price leadership is likely to reflect BT implementing its annual price changes earlier within the year for recent years—indeed, the assumption that price adjustments are annual is incorrect to begin with. In 2014, BT raised prices in December, in 2015 it raised prices in October and in 2016 it raised prices in July (Figures A8.26–A8.28).
- If prior years are taken into account, other CPs adjust their prices prior to BT. In particular, in 2013, Virgin Media adjusted its price first; in 2012, Sky adjusted its price first; and prior to that price adjustments were implemented more than once per year, such that it is no longer meaningful to speak of a CP changing price before or after another CP.

The view taken by Ofcom—that BT is a price leader—is therefore not clear from the limited evidence Ofcom presents.

2.5 Ofcom's approach leads to flawed remedies

We now turn to consider the remedies that Ofcom proposes following its market assessment, and outline the shortcomings in Ofcom's approach to remedies.

⁶⁹ A 25% discount on line rental of £18.99 leads to a line rental of £14.24, a price that Ofcom assumes to be profitable.

Notwithstanding that Ofcom has not substantiated the need for intervention, its analytical approach results in significant shortcomings in respect of remedial action, in terms of what can be imposed (given the SMP finding) and how remedies are imposed.

First, the SMP approach used by Ofcom reduces its flexibility in choice of remedy. Market-wide remedies are artificially ruled out which is inappropriate given the market-wide nature of the concerns identified by Ofcom.

Second, the remedies that Ofcom does propose are disproportionate and will have unintended consequences:

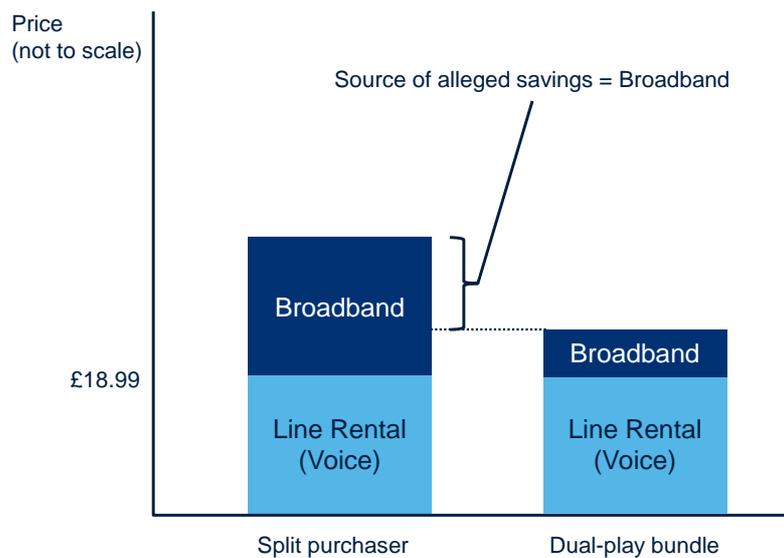
- its proposals do not address the cost of standalone broadband for split purchase customers. The remedy is targeted solely at standalone voice
- Ofcom does not appear to have thought about the impact of the proposed remedies on the migration towards dual play bundles and digital inclusion. The unintended consequences would be detrimental to consumers.

These two problems are analysed below.

2.5.1 The proposed remedies ignore any issues relating to standalone broadband

Ofcom believes that split purchasers pay over the odds when compared to dual play customers (who receive a functionally equivalent service). However, this is supported only by evidence of hypothetical savings by reference to average bundle prices, as opposed to any empirical investigation of savings actually achievable by split purchasers (which will depend on their actual suppliers and purchase prices).

Given that the line rental is the same in the two cases (which Ofcom itself assumes in its analysis of the savings from a split purchase customer moving to dual play), the saving from moving to dual play from split purchase is attributable to a saving on the broadband component, as illustrated in Figure 2.13.

Figure 2.13 Stylised example of savings from dual play bundles

Source: Oxera.

If the saving is attributable solely to the broadband component, it is not immediately clear why a remedy should be applied to the line rental (voice) component. However this is precisely what Ofcom is proposing for these split purchase customers. Furthermore, Ofcom proposes to apply such a remedy to BT only.

We note that BT has only a small share of the broadband component of split purchase customers, at around 17%. This figure is reduced further when accounting for the fact that around [3<] of BT's split purchase customers are BT employees (who receive the service at a reduced rate). Taking this into account BT's share of the broadband component of split purchase customers is likely to be around [3<].⁷⁰ Therefore, not only is Ofcom applying remedies to the wrong product, but also to the wrong firm—BT does not have SMP in standalone broadband.

In summary, Ofcom proposes to apply a remedy on split purchase customers in relation to the line rental price, solely in relation to BT. However, the issue identified by Ofcom relates to the price of *broadband* for split purchase customers, in which BT has a share of less than 20%.

We therefore conclude that Ofcom's proposal to apply SMP obligations on BT for the split purchase customer cohort is disproportionate and inconsistent with the nature of its concerns.

2.5.2 Ofcom has not considered the impact of the proposed remedies on future migration to dual play bundles and digital inclusion

Ofcom's proposed price cut on BT's standalone voice products could significantly reduce the incentive for customers to purchase broadband, and thereby damage the government's stated goal of increasing digital inclusion.⁷¹

⁷⁰ On the basis that there are 200,000 split purchase customers on BT, and some 1.2m split purchase customers (split service + split supply) in total, we get $(200,000 - [3<]) / (1.2m - [3<]) = [3<]$.

⁷¹ See, for example, Cabinet Office (2014), 'Government Digital Inclusion Strategy', policy paper, updated 4 December 2014, <https://www.gov.uk/government/publications/government-digital-inclusion-strategy/government-digital-inclusion-strategy>, accessed 8 May 2017.

The price cut could have an adverse impact on digital inclusion because it would:

- **reduce migration from voice only to dual play:** by increasing the marginal price to a voice-only customer of purchasing a dual play bundle (i.e. the incremental price between dual play bundles and voice-only becomes greater), incentives to migrate to dual play would be reduced, as would the likelihood of those who are digitally excluded (do not have mobile Internet access, etc.) gaining broadband access. There may even be existing dual play customers who migrate back to voice-only and drop broadband altogether thereby increasing the size of the customer base that Ofcom has concerns about;
- **reduce migration from split purchase to dual play and possibly inducing migration from dual play back to split purchase:** by reducing the savings that can be made from split purchasers switching to a dual play bundle. Indeed, if there were negative savings, customers would have the incentive to 'unbundle' and switch from a dual play bundle back to split purchases.

As part of Ofcom's assessment, careful consideration needs to be given to such migration and switching incentives, in order to ensure that any intervention does not have unintended consequences.

Indeed, in other markets Ofcom has taken the migration of legacy services into consideration when deciding on the proportionality of intervention (see Box 2.4). While voice-only may not be classified as a legacy product, there is a clear drive to migrate landline customers onto other products, particularly in light of BT's 'all-IP' transformation objectives.

Box 2.4 Ofcom's approach to the migration of legacy leased lines

In April 2016 Ofcom published the final statement on the Business Connectivity Market Review: Very low bandwidth leased lines.⁷² Ofcom decided to deregulate the prices of these legacy products, and allow BT pricing flexibility (BT pledged to keep price rises below RPI plus 8%).

A key part of Ofcom's consideration in this matter was the fact that prices were a key way of encouraging the migration away from these products:

We also consider that given the context, some price rises need not be an indication of market failure, and may be consistent with a signal to end-users about the need to migrate to alternative services alongside BT's notifications.

We accept that any such pricing signals will not motivate all end-users to migrate onto alternative services, including for the reasons Vodafone suggests. That said, we remain of the view that price rises can play a part in incentivising some end-users to migrate. Alongside any such signals, we have undertaken an extensive programme of engagement to inform [Critical National Infrastructure] operators in numerous sectors of the need to migrate onto alternative services before March 2020.⁷³

Therefore, Ofcom took the forward-looking view that price differentials were helpful in encouraging the migration of customers away from certain products.

Another of Ofcom's considerations was that the retail markets to which the customers were migrating are competitive:

The available alternatives are provided in markets which are typically competitive at the retail level, supported where necessary by regulation at the wholesale level.⁷⁴

This is highly relevant to the question of SFV customers migrating to dual play bundles, as the dual play market is highly competitive.

Source: Oxera.

2.6 Conclusion

In this section we have analysed the robustness of Ofcom's approach to, and conclusions on, market definition and market power in the standalone landline market review.

Our analysis finds that Ofcom has failed to take account of the principles of price discrimination in the context of market definition, which has implications for its conclusion that SFV constitutes a separate relevant economic market. Robustly viewed, the significant migration of SFV customers towards bundles reveals that the boundaries of the market that Ofcom has identified are not stable, which is an important condition (both theoretically and in practice) for separating relevant markets into narrow segments.

Ofcom has also incorrectly defined split purchase and dual play customers as being in separate relevant markets. Instead, we have presented evidence that they should be part of the same market: We find this on the basis of: i) both sets of customers consuming functionally equivalent services; and ii) both sets of consumers having very similar (demographic, market engagement, and mobile usage) characteristics.

Having incorrectly defined a narrow SFV market, Ofcom then finds that BT has SMP. In relation to this, we find that Ofcom has overlooked the competitive constraints faced by BT in respect of the voice-only customer segment. This results in an overstatement of the degree of market power that BT would have for voice-only customers. In particular, BT faces constraints both from mobile

⁷² Ofcom (2016), 'Business Connectivity Market Review: Very low bandwidth leased lines', Statement, 28 April. https://www.ofcom.org.uk/data/assets/pdf_file/0018/63225/final-statement.pdf

⁷³ Ibid., paras. 3.32-3.33.

⁷⁴ Ibid., para. 3.12.

substitution and from the Post Office which is competing actively for voice-only customers.

As a direct result of these shortcomings, Ofcom's proposals to remedy the alleged concerns are inappropriate.

First, SMP has not been properly substantiated for the reasons give above, and therefore there is no clear basis for SMP regulation. Second, Ofcom's approach reduces its flexibility in choice of remedy—market-wide remedies are artificially ruled out. This is inappropriate because the concerns identified by Ofcom (although not properly substantiated) are market-wide in nature.

Second, the remedies proposed by Ofcom are disproportionate and will have unintended consequences. In particular we note that; i) Ofcom's proposals do not address the cost of standalone broadband for split purchase customers. The remedies are targeted solely at standalone voice, when in fact, a significant proportion of the customers Ofcom is concerned about purchase a broadband service from a BT competitor; and ii) Ofcom does not appear to have considered how a deep price cut on standalone line rental might affect the migration towards dual play bundles and digital inclusion. These unintended consequences are likely to be detrimental to consumers.

www.oxera.com