



Mobile call termination market review 2015-18

Annexes 5 and 6

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Annex 5

The regulatory framework

Introduction

- A5.1 This Annex provides an overview of the market review process, to give some additional context to and understanding of the matters discussed in the main body of this document and the draft legal instruments (statutory notifications) published at Annex 7.
- A5.2 Market review regulation is technical and complex, including the legislation and the recommendations and guidelines that we need to consider as part of the process. There may be many relevant documents depending on the market and/or issues in question. This overview does not purport to give a full and exhaustive account of all such materials that we have considered in reaching our preliminary views in these markets. Key aspects of materials relevant to this market review are, however, discussed in this document.

Market review concept

- A5.3 The concept of a market review refers to procedures under which we at regular intervals identify relevant markets appropriate to national circumstances, carry out analyses of these markets to determine whether they are effectively competitive and then decide on appropriate remedies (known as Significant Market Power (SMP) obligations or conditions). We explain the concept of SMP below.
- A5.4 In carrying out this work, we act in our capacity as the independent sectoral regulator for the United Kingdom communications industries. Our functions in this regard are to be found in Part 2 of the Act¹. We exercise those functions within the framework harmonised across the European Union for the regulation of electronic communications by the Member States (known as the Common Regulatory Framework or the CRF), as transposed by the Act. The applicable rules² are contained in a package of five EC Directives, of which two Directives are immediately relevant for these purposes, namely:
- Directive 2002/21/EC on a common regulatory framework for electronic communications networks and services (the Framework Directive); and
 - Directive 2002/19/EC on access to, and interconnection of, electronic communications networks and associated facilities (the Access Directive).
- A5.5 The Directives require that NRAs (such as Ofcom) carry out reviews of competition in communications markets to ensure that SMP regulation remains appropriate and proportionate in the light of changing market conditions.
- A5.6 Each market review normally has three stages, namely:

¹ <http://www.legislation.gov.uk/ukpga/2003/21/contents>

² The Directives have recently been reviewed and amendments were adopted on 19 December 2009. The amendments have been transposed into the national legislation and applied with effect from 26 May 2011.

- the procedure for the identification and definition of the relevant markets (the market definition procedure);
- the procedure for the assessment of competition in each market, in particular whether the relevant market is effectively competitive (the market analysis procedure); and
- the procedure for the assessment of appropriate regulatory obligations (the remedies procedure).

A5.7 These stages are normally carried out together.

Market definition procedure

A5.8 The Act provides that, before making a market power determination³, we must identify (by reference, in particular, to area and locality) the markets, which are in our opinion, the ones which, in the circumstances of the United Kingdom, are the markets in relation to which it is appropriate to consider making such a determination and to analyse that market.

A5.9 The Framework Directive requires that NRAs shall, taking the utmost account of the 2007 EC Recommendation⁴ and SMP Guidelines⁵ published by the EC, define the relevant markets appropriate to national circumstances, in particular relevant geographic markets within their territory, in accordance with the principles of competition law.

A5.10 The 2007 EC Recommendation identifies a set of product and service markets within the electronic communications sector in which *ex-ante* regulation may be warranted. Its purpose is twofold. First, seeking to achieve harmonisation across the single market by ensuring that the same markets will be subject to a market analysis in all Member States. Secondly, providing legal certainty by making market players aware in advance of the markets to be analysed. However, NRAs are able to regulate markets that differ from those identified in the 2007 EC Recommendation where this is justified by national circumstances taking account of the three cumulative criteria referred to in the 2007 EC Recommendation (the “three-criteria test”) and where the EC does not raise any objections. The 2007 EC Recommendation identifies voice call termination on individual mobile networks as one of the markets to be reviewed.

A5.11 Under the three-criteria test, when identifying markets other than those set out in the Recommendation, the NRA needs to ensure that the following three criteria are cumulatively met:

³ The market power determination concept is used in the Act to refer to a determination that a person has SMP in an identified services market.

⁴ *Commission Recommendation of 17 December 2007 on relevant product and service markets within the electronic communications sector susceptible to ex ante regulation in accordance with Directive 2002/21/EC of the European Parliament and of the Council on a common regulatory framework for electronic communication networks and services (2007/879/EC)* available at <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2007:344:0065:0069:en:PDF>.

⁵ *Commission guidelines on market analysis and the assessment of significant market power under the Community regulatory framework for electronic communications networks and services (2002/C 165/03)*, 11 July 2002. Available at <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2002:165:0006:0031:EN:PDF>

- a) the presence of high and non-transitory barriers to entry. These may be of a structural, legal or regulatory nature;
- b) a market structure which does not tend towards effective competition within the relevant time horizon. The application of this criterion involves examining the state of competition behind the barriers to entry; and
- c) the insufficiency of competition law alone to adequately address the market failures concerned.

A5.12 The fact that an NRA identifies the product and services markets listed in the 2007 EC Recommendation or identifies other product and services markets that meet the three-criteria test does not automatically mean that regulation is warranted. Market definition is not an end in itself but rather a means of assessing effective competition. The three-criteria test is also different from the SMP assessment because the test's focus is on the general structure and market characteristics.

A5.13 On 24 January 2014, the Commission published a draft of the revised EC Recommendation on the relevant product and service markets, as well as a draft explanatory note to that recommendation.⁶ The market for wholesale voice call termination on individual mobile networks is included in the draft revised EC Recommendation.

A5.14 The SMP Guidelines make clear that market definition is not a mechanical or abstract process. It requires an analysis of any available evidence of past market behaviour and an overall understanding of the mechanics of a given sector. As market analyses have to be forward-looking, the Guidelines state that NRAs should determine whether the market is prospectively competitive, and thus whether any lack of effective competition is durable, by taking into account expected or foreseeable market developments over the course of a reasonable period. They clarify that NRAs enjoy discretionary powers that reflect the complexity of all the relevant factors that must be assessed (economic, factual and legal) when identifying the relevant market, and assessing whether an undertaking has SMP.

A5.15 The SMP Guidelines also describe how competition law principles may be used by NRAs in their analyses. In particular, there are two dimensions to the definition of a relevant market: the relevant products to be included in the same market and the geographic extent of the market. Ofcom's approach to market definition follows that used by the United Kingdom competition authorities, which is in line with the approaches adopted by the EC.

A5.16 While such principles are being used in identifying the *ex-ante* markets, they will not necessarily be identical to markets defined in individual competition law cases. This may be the case, especially as the former is based on an overall forward-looking assessment of the structure and the functioning of the market under examination. Accordingly, the economic analysis carried out for the purpose of this review, including the identified markets, is without prejudice to any analysis that may be carried out in relation to any investigation pursuant to the Competition Act 1998⁷

⁶ Available at <http://ec.europa.eu/digital-agenda/en/news/commission-requests-berec-opinion-draft-revised-recommendation-relevant-markets>

⁷ <http://www.legislation.gov.uk/ukpga/1998/41/contents>

(relating to the application of the Chapter I or II prohibitions or Article 101 or 102 of the Treaty on the Functioning of the European Union⁸) or the Enterprise Act 2002⁹.

Market analysis procedure

Effective competition

- A5.17 The Act requires that we carry out market analyses of identified markets for the purpose of making or reviewing market power determinations. Such analyses are normally to be carried out within 2 years from the adoption of a revised recommendation on markets, where such recommendation identifies a market not previously notified to the EC, or within 3 years from the publication of a previous market power determination relating to that market. In this case, however, we aim at completing our market analysis by publishing a final statement in March 2015 (i.e. 4 years since the last market review). This is because the requirement to review an earlier market power determination within a 3-year period does not apply to this market review¹⁰ and the charge control measures imposed by the 2011 Statement will expire on 31 March 2015.
- A5.18 In carrying out a market analysis, the key issue for an NRA is to determine whether the market in question is effectively competitive. The 27th recital to the Framework Directive clarifies the meaning of that concept. Namely, “[it] is essential that ex-ante regulatory obligations should be imposed only where there is not effective competition, i.e. in markets where there are one or more undertakings with significant market power, and where national and Community competition law remedies are not sufficient to address the problem”.
- A5.19 The definition of SMP is equivalent to the concept of dominance as defined in competition law. This is provided for by Article 14 of the Framework Directive as implemented by section 78 of the Act. The Framework Directive requires, however, that NRAs must carry out the market analysis taking the utmost account of the SMP Guidelines. The latter emphasise that NRAs should undertake a thorough and overall analysis of the economic characteristics of the relevant market before coming to a conclusion as to the existence of significant market power.
- A5.20 In that regard, the SMP Guidelines set out, additionally to market shares, a number of criteria that can be used by NRAs to measure the power of an undertaking to behave to an appreciable extent independently of its competitors, customers and consumers, including (a) overall size of the undertaking; (b) control of infrastructure not easily duplicated; (c) technological advantages or superiority; (d) absence of or low countervailing buying power; (e) easy or privileged access to capital markets/financial resources; (f) product/services diversification (e.g. bundled products or services); (g) economies of scale; (h) economies of scope; (i) vertical integration; (j) highly developed distribution and sales network; (k) absence of potential competition; and (l) barriers to expansion. A dominant position can derive

⁸ Previously Article 81 and Article 82 of the EC Treaty, <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2010:083:FULL:EN:PDF>

⁹ <http://www.legislation.gov.uk/ukpga/2002/40/contents>

¹⁰ The Act was amended on 26 May 2011 to include these requirements under section 84A following amendment to the Directives on 19 December 2009. However, the Electronic Communications and Wireless Telegraphy Regulations 2011 (SI 2011/1210), which introduced these amendments to the Act, provided for a transitional provision which means that the requirement to notify the EC within 3 years from a previous market power determination only applies where that market power determination was made after 25 May 2011 (see section 84A(4) of the Act). The market power determinations under review in this document were made prior to 25 May 2011.

from a combination of these criteria, which taken separately may not necessarily be determinative.

Sufficiency of competition law

A5.21 As part of our overall forward-looking analysis, we also assess whether competition law by itself (without *ex-ante* regulation) is sufficient to address the competition problems identified. Aside from the need to address this issue as part of the three-criteria test, we also consider this matter in our assessment of the appropriate remedies which, as explained below, are based on the nature of the specific competition problems we identify within the relevant markets as defined. Our analysis in this regard is set out in Section 5 at paragraphs 5.31 – 5.38.

Remedies procedure

Powers and legal tests

- A5.22 The Framework Directive prescribes what regulatory action NRAs must take depending upon whether or not the market in question has been found effectively competitive. Where a market has been found to be effectively competitive, NRAs are not allowed to impose SMP obligations and must withdraw such obligations where they already exist. On the other hand, where the market is found not to be effectively competitive, the NRAs must identify the undertakings with SMP on that market and then impose appropriate obligations on them.¹¹
- A5.23 NRAs have a suite of regulatory tools at their disposal, as reflected in sections 87-91 of the Act. Specifically, the Access Directive specifies a number of SMP obligations, including transparency, non-discrimination, accounting separation, access to and use of specific network elements and facilities, price control and cost accounting. When imposing a specific obligation, the NRA will need to demonstrate that the obligation in question is based on the nature of the problem identified, proportionate and justified in the light of the policy objectives as set out in Article 8 of the Framework Directive.¹²
- A5.24 Specifically, for each and every proposed SMP obligation we explain why it satisfies the test that the obligation is: (a) objectively justifiable in relation to the networks, services, facilities, apparatus or directories to which it relates; (b) not such as to discriminate unduly against particular persons or against a particular description of persons; (c) proportionate to what the condition or modification is intended to achieve; and (d) in relation to what it is intended to achieve, transparent.¹³
- A5.25 Additional legal requirements may also need to be satisfied depending on the SMP obligation in question, for example, for price controls where the NRA's market analysis must indicate that the lack of effective competition means that the MCP concerned might sustain prices at an excessively high level, or apply a price squeeze, to the detriment of end-users. In that instance, NRAs must take into account the investment made by the MCP and allow him a reasonable rate of return on adequate capital employed, taking into account the risks involved, as well as

¹¹ See Article 16(3) and (4) of the Framework Directive; sections 84 and 87(1) of the Act.

¹² See Article 8(4) of the Access Directive.

¹³ Section 47 of the Act; Article 8(5) of the Framework Directive and Article 5(2) of the Access Directive.

ensure that any cost recovery mechanism or pricing methodology that is mandated serves to promote efficiency and sustainable competition and maximise consumer benefits.¹⁴ Where an obligation to provide third parties with network access is considered appropriate, NRAs must take into account factors including the feasibility of the proposed network access, the technical and economic viability of creating networks¹⁵ that would make the network access unnecessary, the investment of the network MCP which is required to provide access¹⁶ and the need to secure effective competition¹⁷ in the long term.¹⁸

Ofcom's general duties - section 3 of the Act

- A5.26 Under the Act, our principal duty in carrying out functions is to further the interests of citizens in relation to communications matters and to further the interests of consumers in relevant markets, where appropriate by promoting competition (section 3(1)).
- A5.27 In so doing, we are required to secure a number of specific objectives, including securing the availability of a wide range of electronic communications services throughout the UK (section 3(2)(b)).
- A5.28 In performing our duties, we are also required to have regard to a range of other considerations, as appear to us to be relevant in the circumstances. In this context, we consider that a number of such considerations are relevant, namely:
- the desirability of promoting competition in relevant markets (section 3(4)(b)); and
 - the desirability of encouraging investment and innovation in relevant markets (section 3(4)(d)).
- A5.29 We must also have regard to the principles under which regulatory activities should be transparent, accountable, proportionate, consistent, and targeted only at cases in which action is needed (section 3(3)), as well as the interest of consumers in respect of choice, price, quality of service and value for money (section 3(5)).
- A5.30 Ofcom has, however, a wide measure of discretion in balancing its statutory duties and objectives. In so doing, we take account of all relevant considerations, including responses received during our consultation process, in reaching our conclusions.

European Community requirements for regulation - sections 4 and 4A of the Act and Article 3 of the BEREC Regulation

- A5.31 Our functions exercised in this review fall under the CRF. As such, section 4 of the Act requires us to act in accordance with the six European Community requirements for regulation. Where it appears to Ofcom that any of their general duties conflict with one or more of their duties under section 4, priority must be given to those latter duties (section 3(6)).

¹⁴ Section 88 of the Act, which implements Article 13 of the Access Directive.

¹⁵ Including the viability of other network access products, whether provided by the dominant provider or another person.

¹⁶ Taking account of any public investment made.

¹⁷ Including, where it appears to us to be appropriate, economically efficient infrastructure-based competition.

¹⁸ Section 87 of the Act.

A5.32 In summary, these six requirements are:

- to promote competition in the provision of electronic communications networks and services, associated facilities and the supply of directories;
- to contribute to the development of the European internal market;
- to promote the interests of all persons who are citizens of the European Union;
- to take account of the desirability of Ofcom carrying out its functions in a manner which, so far as practicable, does not favour one form of or means of providing electronic communications networks, services or associated facilities over another – i.e. to be technologically neutral;
- to encourage the provision of network access and service interoperability, to such extent as Ofcom considers appropriate for the purpose of securing efficient and sustainable competition, efficient investment and innovation, and the maximum benefit for customers of CPs;
- to encourage compliance with certain standards in order to facilitate service interoperability and secure freedom of choice for the customers of CPs.

A5.33 We consider that the first, second, third, fourth and fifth of those requirements are of particular relevance to the matters under review and that no conflict arises in this regard with those specific objectives in section 3 of the Act that we consider are particularly relevant in this context.

A5.34 Section 4A of the Act requires Ofcom, in carrying out certain of its functions (including, among others, Ofcom's functions in relation to market reviews under the CRF) to take due account of applicable recommendations issued by the EC under Article 19(1) of the Framework Directive, which aim to achieve the harmonised application of provisions of the CRF and the achievement of the objectives set out in Article 8 of the Framework Directive. Where we decide not to follow such a recommendation, we must notify the EC of that decision and the reasons for it.

A5.35 Similarly, Article 3(3) of the Regulation establishing BEREC¹⁹ requires NRAs to take utmost account of any opinion, recommendation, guidelines, advice or regulatory best practice adopted by BEREC.

A5.36 Accordingly, we have taken due account of the applicable EC recommendations and utmost account of the applicable opinions, recommendations, guidelines, advice and regulatory best practices adopted by BEREC relevant to the matters under consideration in this review.

The 2009 EC Recommendation

A5.37 In 2009, the European Commission issued a Recommendation on the Regulatory Treatment of Fixed and Mobile Termination Rates²⁰ under Article 19(1) of the

¹⁹ Regulation (EC) No 1211/2009 of the European Parliament and of the Council of 25 November 2009 establishing the Body of European Regulators of Electronic Communications (BEREC) and the Office ('the BEREC Regulation') <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32009R1211&from=EN>.

Framework Directive. This recommends that Member States adopt a common approach when setting price controls.

- A5.38 The 2009 EC Recommendation favours recovering elements of common costs not from wholesale termination but from the competitive retail side of the mobile market, based on a bottom-up long-run incremental cost methodology. The Recommendation also outlines the EC's view that all termination charges should be symmetrical.
- A5.39 We consider that the Recommendation is relevant to this market review, and that, therefore, we must have regard to it in determining our proposals and, in accordance with section 4A of the Act, Ofcom is obliged to take it into account.
- A5.40 Further, we consider that when having regard to the Recommendation we must take account of both the course of action which it recommends in relation to setting charge control and cost accounting obligations (the content of the Recommendation) and the harmonising objective or intent of the Recommendation. We discuss the 2009 EC Recommendation in Section 2 at paragraphs 2.8 - 2.9..

Regulated entity

- A5.41 The power in the Act to impose an SMP obligation by means of an SMP services condition provides that it is to be applied only to a 'person' whom we have determined to be a 'person' having SMP in a specific market for electronic communications networks, electronic communications services or associated facilities (i.e. the 'services market').
- A5.42 The Framework Directive requires that, where an NRA determines that a relevant market is not effectively competitive, it shall identify 'undertakings' with SMP on that market and impose appropriate specific regulatory obligations. For the purposes of EC competition law, 'undertaking' includes companies within the same corporate group (*Viho v Commission* Case C-73/95 P [1996] ECR I-5447²¹), for example, where a company within that group is not independent in its decision making.
- A5.43 We consider it appropriate to prevent a dominant provider to whom a SMP service condition is applied, which is part of a group of companies, from exploiting the principle of corporate separation. The dominant provider should not use another member of its group to carry out activities or to fail to comply with a condition, which would otherwise render the dominant provider in breach of its obligations.

²⁰ Commission Recommendation of 7 May 2009 on the Regulatory Treatment of Fixed and Mobile Termination Rates in the EU (2009/396/EC) at <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:124:0067:0074:EN:PDF>.

²¹ <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:61995CJ0073:EN:PDF>

Annex 6

General analytical approach to market definition and SMP assessment

Introduction

A6.1 This Annex sets out in general terms the processes that we have followed in defining the markets within this review, how and on what basis we assess whether anyone has SMP in a given market, whether SMP conditions should be imposed in a relevant market, and in what form. Sections 3 to 5 (market definition and SMP analysis) set out in more detail how we have applied our approach in each relevant market.

The time period under review

A6.2 Rather than just looking at the current position, market reviews look ahead to how competitive conditions may change in future. Our evaluation of the current market takes into account past developments and evidence, before then considering the foreseeable market changes that we expect to affect its development over the period to April 2017. This forecast period reflects the period covered by this market review.

A6.3 The forward look period that we have used does not preclude us reviewing the market before that point should the market develop in way we have not foreseen to the extent that it is likely to affect the competitive conditions that are operating.

Approach to market definition

A6.4 In defining markets for market review purposes, our main EU law obligation is to define relevant markets appropriate to national circumstances in accordance with the principles of competition law, taking the utmost account of the 2007 EC Recommendation²² and the SMP Guidelines²³ published by the EC.²⁴

A6.5 There are two dimensions to the definition of the relevant market: the relevant products to be included within the market and the geographic extent of the market. It is often practical to define the relevant product market before exploring the geographic dimension of the market.

A6.6 While we describe below our analytical approach to market definition, it should be borne in mind that this is not a mechanical or abstract process. The approach is a dynamic one based on our overall understanding of the relevant markets, taking

²² Commission Recommendation of 17 December 2007 on relevant product and service markets within the electronic communications sector susceptible to ex ante regulation in accordance with Directive 2002/21/EC of the European Parliament and of the Council on a common regulatory framework for electronic communication networks and services (2007/879/EC) available at <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2007:344:0065:0069:en:PDF>.

²³ Commission guidelines on market analysis and the assessment of significant market power under the Community regulatory framework for electronic communications networks and services (2002/C 165/03), 11 July 2002, www.eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2002:165:0006:0031:EN:PDF.

²⁴ Article 15(3) of the Framework Directive.

account of available evidence of past behaviour as well as our forward-looking analysis over the forecast period, reflecting the characteristics of the relevant retail and wholesale markets and the factors likely to influence their competitive development.

- A6.7 It should therefore be recognised that the market definition exercise is not an end in itself, but, rather, a means to an end. Market definition aids the assessment of whether end-users of a product are protected by effective competition and thus whether there is a requirement for the imposition of *ex-ante* regulation. It is in this light that we have conducted our market definitions in this review.
- A6.8 In particular, when identifying markets that differ from those in the 2007 EC Recommendation, the three criteria test is applied to identify markets that are susceptible to *ex-ante* regulation. The market definition exercise goes to this end.
- A6.9 To re-iterate, the three criteria that must cumulatively be met are:²⁵
- the presence of high and non-transitory barriers to entry, which may be of a structural, legal or regulatory nature;
 - a market structure which does not tend towards effective competition within the relevant time horizon (the application of this criterion involves examining the state of competition behind the barriers to entry); and
 - the insufficiency of competition law alone to adequately address the market failure(s) concerned.
- A6.10 If these conditions are met, it may be appropriate to impose *ex-ante* regulation in the market. In formulating our proposals, we have taken utmost account of the SMP Guidelines and the 2007 EC Recommendation as well as the accompanying Explanatory Memorandum (the 'Explanatory Memorandum').²⁶

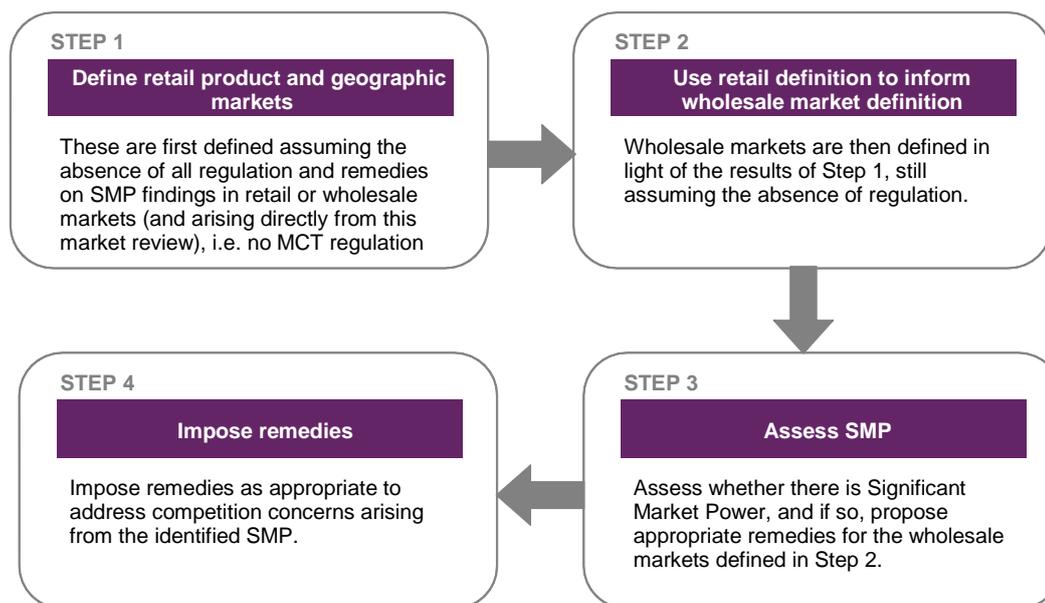
Sequencing of our analysis

- A6.11 We now provide an overview of the stages involved in assessing whether or not it is appropriate to impose *ex-ante* regulation. Figure A6.1 sets out the sequencing of our analysis.

²⁵ As set out in recital 5 and point 2 of the 2007 EC Recommendation.

²⁶ *Explanatory note accompanying the Commission recommendation on relevant product and service markets within the electronic communications sector susceptible to ex ante regulation in accordance with Directive 2002/21/EC of the European Parliament and the Council on a common regulatory framework for electronic communications networks and services*, available at: www.ec.europa.eu/information_society/policy/ecomms/doc/implementation_enforcement/eu_consultation_procedures/sec_2007_1483_2.pdf.

Figure A6.1: Sequencing of market definition, SMP and remedies analysis



- A6.12 The order in which we carry out the various steps is linked with another aspect that often needs to be taken into account – especially in the electronic communications sector – namely the level of the supply chain (e.g. retail, wholesale) that is being analysed. Our usual starting point for identifying markets where there may be a requirement for the imposition of *ex-ante* regulation is the definition of retail markets from a forward-looking perspective (Step 1). The wholesale market is defined subsequent to this exercise being carried out (Step 2).
- A6.13 The analysis of retail market definition is logically prior to the definition of wholesale markets because the demand for the upstream wholesale service is a derived demand – i.e. the level of the demand for the upstream input depends on the demand for the retail service. Hence the range of available substitutes at the downstream (retail) level will inform the likely range of substitutes for the upstream (wholesale) service. This is because a rise in the price of a wholesale service which is passed through in the price of downstream retail services will cause retail customers to switch to substitute retail products, reducing demand for the wholesale input. We refer to this as an indirect constraint.
- A6.14 Consequently, Step 1 (retail market definition) and Step 2 (wholesale market definition) should be regarded as one exercise, the ultimate purpose of which is to define those wholesale markets in the UK where there may be a requirement for the imposition of *ex-ante* regulation.²⁷
- A6.15 We have thus considered the definition of retail and wholesale markets and, in relevant cases, whether the wholesale market is one in which *ex-ante* regulation may be appropriate (if so, we have then formally identified a relevant market).²⁸ Step 3 in our analysis is assessing whether or not there is SMP. In the event that

²⁷ See, in this respect, recital 4 of the 2007 EC Recommendation which states that “[h]aving defined retail markets, it is then appropriate to identify *relevant* wholesale markets” (emphasis added) www.ec.europa.eu/information_society/policy/ecomm/doc/library/proposals/rec_markets_en.pdf). See also section 2.1 of the Explanatory Note to the 2007 EC Recommendation and paragraph 44 of the SMP Guidelines.

²⁸ See recital 5 and point 2 of the 2007 EC Recommendation.

we find that SMP exists, we then go on to consider appropriate remedies for the relevant market (Step 4).

Market definition

Demand-side and supply-side substitution

- A6.16 Market boundaries are determined by identifying constraints on the price setting behaviour of firms.²⁹ There are two main constraints to consider:
- first, to what extent it is possible for a customer to substitute other services for those in question in response to a relative price increase ('demand-side substitution'); and
 - second, to what extent suppliers can switch, or increase, production to supply the relevant products or services in response to a relative price increase ('supply-side substitution').
- A6.17 The hypothetical monopolist test (HMT) is a useful tool often used to identify close demand-side and supply-side substitutes. In this test, a product is considered to constitute a separate market if the hypothetical monopolist supplier could impose a small but significant non-transitory increase in price (SSNIP) above the competitive level without losing sales to such a degree as to make this price rise unprofitable. If such a price rise would be unprofitable, because consumers would switch to other products or because suppliers of other products would begin to compete with the hypothetical monopolist, then the market definition should be expanded to include the substitute products.
- A6.18 We must first therefore address the issue of which product(s) should form the starting point for the application of the HMT. We refer to this starting point as the 'focal product.'³⁰ Paragraph 41 of the SMP Guidelines states that "*As a starting point, an NRA should apply this test firstly to an electronic communications service or product offered in a given geographical area, the characteristics of which may be such as to justify the imposition of regulatory obligations ...*"
- A6.19 We define markets first on the demand-side, considering if other services could be considered as substitutes by consumers in the event of the hypothetical monopolist supplier introducing a SSNIP above the competitive level.
- A6.20 Then, where relevant, we assess supply-side substitution possibilities to consider whether they provide any additional constraints on the pricing behaviour of the hypothetical monopolist which have not been captured by the demand-side analysis. In this assessment, supply-side substitution is considered to be a low cost form of entry which can take place within a reasonable timeframe (e.g. up to 12 months). The key point is that, for supply-side substitution to be relevant, not only must suppliers be able, in theory, to enter the market quickly and at low cost by virtue of their existing position in the supply of other products or geographic areas, but there must also be an additional competitive constraint arising from such entry into the supply of the service in question.

²⁹ See paragraph 38 of the SMP Guidelines.

³⁰ This reflects the terminology used by the OFT (OFT, *Market definition*, December 2004, OFT403, www.of.gov.uk/shared_of/business_leaflets/ca98_guidelines/oft403.pdf).

A6.21 Therefore, in identifying potential supply-side substitutes, it is important that providers of these services have not already been taken into consideration. There might be suppliers who provide other services but who might also be materially present in the provision of demand-side substitutes to the service for which the hypothetical monopolist has raised its price. Such suppliers are not relevant to supply-side substitution since they supply services already identified as demand-side substitutes. As such, their entry has already been taken into account and so supply-side substitution from these suppliers cannot provide an additional competitive constraint on the hypothetical monopolist. However, the impact of expansion by such suppliers can be taken into account in the assessment of market power.

Bundling

A6.22 A common feature of the telecoms sector is the supply of bundles of different services. The Explanatory Memorandum to the 2007 EC Recommendation explains that in most cases the individual services in a bundle are not good demand-side substitutes of each other, yet may be considered as part of the same retail market if there is no independent demand for individual parts of the bundle.

A6.23 However, the Explanatory Memorandum goes on to say that if, in the presence of a SSNIP there is evidence that a sufficient number of customers would “unpick” the bundle and obtain the service elements of the bundle separately, then it can be concluded that the service elements constitute the relevant markets in their own right.

A6.24 BEREC’s report on bundles expands on this and says that economies of scope and transaction cost savings might make it less likely that consumers will “unpick” a bundle.³¹ It also suggests that evidence relating to consumer switching between bundled and unbundled products, switching costs, and the take-up of bundles compared to individual products (and the availability of individual products) can be used to infer substitutability of bundled and unbundled products.

Homogeneous competitive conditions

A6.25 In certain circumstances, it may also be appropriate to define a product market by grouping together services which are subject to homogeneous competitive conditions, despite the absence of demand- and supply-side substitutability. Homogeneity of competitive conditions is chiefly used in defining geographic markets to combine, into a single market, different geographic areas in which competitive conditions are nonetheless sufficiently homogeneous. However, it can also be used in the product market definition analysis. This approach can help streamline the subsequent market power analysis by reducing the need to review multiple markets for products the provision of which is subject to homogeneous competitive conditions.

A6.26 However, combining products and services based on homogenous competition conditions, is – by definition – only appropriate where this would not alter any subsequent findings on SMP (relative to defining those markets separately and making separate market power assessments accordingly). Provided this is the case, then we consider applying this criterion to both our product and geographic

³¹ BEREC, BoR (10) 64, *BEREC report on the impact of bundled offers in retail and wholesale market definition*, December 2010, http://berec.europa.eu/eng/document_register/subject_matter/berec/reports/?doc=209.

market definition analysis is appropriate since market definition, as explained above, is a means to an end and the end is an assessment of the effectiveness of competition in the relevant market which involves carrying out the market power analysis.

A6.27 Our approach also takes into account the SMP Guidelines. In particular, paragraph 56 of the SMP Guidelines states that:

“According to established case-law, the relevant geographic market comprises an area in which the undertakings concerned are involved in the supply and demand of the relevant products or services, in which area the conditions of competition are similar or sufficiently homogeneous and which can be distinguished from neighbouring areas in which the prevailing conditions of competition are appreciably different...”

A6.28 Hence, subject to the relevant caveats above, where there are geographic areas where competitive conditions are sufficiently homogeneous, the definition of the relevant geographic market will include all of those areas within one market.

Common pricing constraints

A6.29 Another factor that is sometimes considered in setting market boundaries is whether there exist common pricing constraints across customers, services or geographic areas (i.e. areas in which a firm voluntarily offers its services at a geographically uniform price). Where common pricing constraints exist, the geographic areas in which they apply could be included within the same relevant market even if demand-side and supply-side substitutes are not present. Failure to consider the existence of a common pricing constraint could lead to unduly narrow markets being defined.

Relevance of existing regulation – the modified Greenfield approach

A6.30 When we conduct our analysis to define the relevant retail and wholesale markets we assume that there is no SMP regulation in place in the market under consideration or in downstream markets – the so-called ‘modified Greenfield approach’.³²

A6.31 This approach means we conduct Step 1 and Step 2 of the approach set out in Figure A9.1 in the absence of SMP regulation. To do otherwise would mean that the subsequent wholesale market power assessment (Step 3) would be informed by a previous retail market definition that itself relied on a wholesale regulatory remedy arising from the finding of wholesale market power. This would be a circular and incorrect approach to market definition.

A6.32 However, at both Steps 1 and 2, it remains appropriate to take into account *ex-ante* regulation arising from SMP findings in markets other than those being defined. Further, having defined the wholesale market, it may be necessary to go on to consider whether *ex-ante* regulation is necessary at the retail level. In carrying out this retail level assessment, it is appropriate to take into account any regulation that is upstream of the market being considered, as upstream regulation (e.g. wholesale remedies) has the potential to affect the competitive state of downstream (i.e. retail)

³² See also section 2.5 of the Explanatory Note to the 2007 EC Recommendation.

markets (indeed, this is generally one of the main intentions of upstream regulation).

Geographic market

- A6.33 In addition to the product(s) to be included within a market, market definition also requires the geographic extent of the market to be specified. The geographic market is the area within which demand side and/or supply side substitution can take place and is defined using a similar approach to that used to define the product market. We have considered the geographic extent of each relevant market covered in this market review.
- A6.34 There are a number of possible approaches to geographic market definition. One approach would be to begin with a narrowly-defined area and then consider whether a price increase by a hypothetical monopolist in that narrowly defined area would encourage customers to switch to suppliers located outside the area (demand-side substitution) or CPs outside the area to begin to offer services in the area (supply-side substitution). If demand and/or supply side substitution is sufficient to constrain prices then it is appropriate to expand the geographic market boundary.
- A6.35 We recognise that in certain communications (product) markets in the UK, there could be different competitive pressures in different geographic areas. In this case, we therefore have to consider whether it would be appropriate to identify separate geographic markets for some services (note also that the discussion above about homogenous competitive conditions and common pricing constraints is relevant). Defining separate markets by geographic area may be problematic because, due to the dynamic nature of communications markets, the boundary between areas where there are different competitive pressures may be unstable and change over time, rendering the market definition obsolete.
- A6.36 An alternative approach is to define geographic markets in a broader sense. This involves defining a single geographic market but recognising that this single market has local geographical characteristics. That is to say, recognising that within the single market there are geographic areas where competition is more developed than in other geographic areas. This avoids the difficulties of proliferation and instability in the definition.

Market power assessment

- A6.37 As we recognise above, market definition is not an end in itself. The definition of the scope of the relevant economic market is carried out in order to identify the product(s) and the geographic area over which a competition assessment can be made of CPs' ability to act to an appreciable extent independently of competitors, customers and consumers, i.e. whether there are any CPs that hold a position of SMP within a particular market.

Definition of SMP

- A6.38 Sections 45, 46 and 78 of the Act grant us the power under certain circumstances to set conditions which require CPs to do certain things. Specifically, sections 46(7) and 46(8) state that SMP services conditions may be imposed on a particular person who is either a CP or a person who makes associated facilities available, and who has been determined to have SMP in a services market (i.e. a specific

market for electronic communications networks, electronic communications services or associated facilities).

A6.39 Accordingly, having identified the relevant product and geographic market(s) and, where relevant having identified the market as susceptible to *ex-ante* regulation, we go on to analyse each market in order to assess whether any person or persons have SMP as defined in section 78 of the Act (construed in accordance with Article 14 of the Framework Directive). Section 78 of the Act provides that SMP is defined as being equivalent to the competition law concept of dominance in accordance with Article 14(2) of the Framework Directive which provides:

“An undertaking shall be deemed to have significant market power if, either individually or jointly with others, it enjoys a position equivalent to dominance, that is to say a position of economic strength affording it the power to behave to an appreciable extent independently of competitors, customers and ultimately consumers.”

A6.40 Further, Article 14(3) of the Framework Directive states that:

“Where an undertaking has significant market power on a specific market, it may also be deemed to have significant market power on a closely related market, where the links between the two markets are such as to allow the market power held in one market to be leveraged into the other market, thereby strengthening the market power of the undertaking.”

A6.41 Therefore, in the relevant market, one or more undertakings may be designated as having SMP where that undertaking or undertakings enjoy a position of dominance. Also, an undertaking may be designated as having SMP where it could lever its market power from a closely related market into the relevant market, thereby strengthening its market power in the relevant market.

A6.42 In assessing whether an undertaking has SMP, we take due account of the EC SMP Guidelines as we are required to do under section 79 of the Act.

The criteria for assessing SMP

A6.43 The SMP Guidelines require NRAs to assess whether competition in a market is effective. This assessment is undertaken through a forward looking evaluation of the market (i.e. determining whether the market is prospectively competitive), taking into account foreseeable developments and a number of relevant criteria.³³

A6.44 Our assessments of SMP are concerned with the prospects for competition over the review period of three years. Ultimately, we want to understand how the markets are likely to develop, and whether competition is likely to be, or become, effective during this review period. Below we set out certain key factors that we are likely to consider when assessing SMP.³⁴

³³ See, for example, paragraphs 19 and 20, and the opening words of paragraph 75, of the SMP Guidelines.

³⁴ The factors listed in this Annex are not intended to be exhaustive – other evidence may be relevant. Paragraph 78 of the SMP Guidelines lists the following criteria that could be used to assess market power: overall size of the undertaking; control of infrastructure not easily duplicated; technological advantages or superiority; absence of, or low, countervailing buying power; easy or privileged access to capital markets/financial resources; product/services diversification (e.g. bundled products or

- A6.45 Where a market is found to be competitive then no SMP conditions can be imposed. Section 84(4) of the Act requires that any SMP condition in that market, applying to a person by reference to a market power determination made of the basis of an earlier analysis, must be revoked.

Market shares

- A6.46 In the EC SMP Guidelines, the EC discusses market shares as being an indicator of (although not sufficient alone to establish) market power:

“...Market shares are often used as a proxy for market power. Although a high market share alone is not sufficient to establish the possession of significant market power (dominance), it is unlikely that a firm without a significant share of the relevant market would be in a dominant position. Thus, undertakings with market shares of no more than 25% are not likely to enjoy a (single) dominant position on the market concerned. In the Commission's decision making practice, single dominance concerns normally arise in the case of undertakings with market shares of over 40%, although the Commission may in some cases have concerns about dominance even with lower market shares, as dominance may occur without the existence of a large market share. According to established case-law, very large market shares — in excess of 50% — are in themselves, save in exceptional circumstances, evidence of the existence of a dominant position...”³⁵

- A6.47 Market shares and market share trends provide an indication of how competitive a market has been in the past. If a firm has a persistently high market share, then that in itself gives rise to a presumption of SMP. However, changes in market share are also relevant to our assessment of prospects for competition. For example, a market share trend which shows a decline may suggest that competition will provide an effective constraint within the time period over which the SMP assessment is being conducted, although it does not preclude the finding of SMP.³⁶

Barriers to entry and expansion

- A6.48 Entry barriers are important in the assessment of potential competition.³⁷ The lower entry barriers are, the more likely it is that potential competition will prevent undertakings already within a market from profitably sustaining prices above competitive levels. Moreover, the competitive constraint imposed by potential entrants is not simply about introducing a new product to the market. To be an effective competitive constraint, a new entrant must be able to attain a large enough scale to have a competitive impact on undertakings already in the market. This may entail entry on a small scale, followed by growth. Accordingly, whether there are barriers to expansion is also relevant to an SMP assessment. Many of the factors that may make entry harder might also make it harder for undertakings that have recently entered the market to expand their market shares and hence their competitive impact.

services); economies of scale; economies of scope; vertical integration; a highly developed distribution and sales network; absence of potential competition; and barriers to expansion.

³⁵ Paragraph 75 of the SMP Guidelines.

³⁶ See, for example, paragraph 75 of the SMP Guidelines.

³⁷ Paragraph 80 of the SMP Guidelines.

- A6.49 A related factor is the growth in demand in the market. In general, CPs are more willing to invest in a growing market (and less willing in a declining market). As a result, barriers to entry and expansion tend to be less of an impediment to competition in rapidly growing markets.

Countervailing buyer power

- A6.50 A concentrated market need not lead to harmful outcomes if buyers have sufficient countervailing buyer power to curtail the exercise of market power. In general, purchasers may have a degree of buyer power where they purchase large volumes and can make a credible threat to switch supplier or to meet their requirements through self-supply to a significant degree. It is important to note, however, that the volumes involved must be large enough to make a material difference to the profitability of the current supplier. That is, an individual wholesale customer must represent a significant proportion of the total volume supplied by the relevant CP.

Excessive pricing and profitability

- A6.51 In a competitive market, individual firms should not be able to persistently raise prices above costs and sustain excess profits. As costs fall, prices should be expected to fall too if competition is effective.
- A6.52 The ability, therefore, to price at a level that keeps profits persistently and significantly above the competitive level is an important indicator of market power. The SMP Guidelines refer to the importance, when assessing market power on an ex-ante basis, of considering the power of undertakings to raise prices without incurring a significant loss of sales or revenue (factors that may explain excess profits in the short term, such as greater innovation and efficiency, or unexpected changes in demand, should however be considered in interpreting high profit figures).³⁸

The reverse is not true: consistently low profits, i.e. profits at or below the cost of capital, cannot be taken as evidence of an absence of market power. It may simply be evidence of inefficiency. For example, if a firm with SMP were to have inefficiently high costs, it may charge a price above the level we would expect to see in a competitive market but this would not result in high profits. In addition, price regulation exists in many of the wholesale markets considered, and therefore low profits may simply be the result of regulation rather than a reflection of the underlying competitive conditions.

³⁸ Paragraph 73 of the SMP Guidelines.