



Retail Bundling in Hull

KCOM Bundling of SMP and non-SMP Products

Statement

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Section 1

Summary

- 1.1 This statement sets out our decision to allow KC, part of the KCOM Group PLC, ("KCOM") to bundle broadband, landline and other services for customers in the Hull area in a way that is similar to packages offered by the other Communication Providers throughout the UK. It follows from our consultation 'Retail Bundling in Hull' ("the Consultation"), published on 5 August 2010.
- 1.2 In the review of the retail narrowband telephony markets of 15 September 2009 we concluded that in the Hull area KCOM retained Significant Market Power (SMP) in all retail narrowband markets and existing wholesale and retail regulations were retained, including the requirement that retail services were offered with no undue discrimination. We noted, however, that as a consequence of our interpretation of the no undue discrimination rule, there was a continuing restriction on the bundling of retail services in the Hull area which appeared to impact disproportionately on the choices available to Hull consumers.
- 1.3 The Consultation sought views on a framework which would allow KCOM to bundle SMP and non-SMP services at the retail level while remaining subject to certain safeguards to ensure that the change did not unduly impact on the incentives for other communications companies to offer retail services in Hull in the future. In particular we proposed that such bundles should be allowed provided that:
 - they are made available to all residents and businesses in the Hull area;
 - the prices of the bundles are published on KCOM's website; and
 - prices are set in a way that would not discourage other communications providers from offering services to consumers in Hull, should they wish to do so in the future.
- 1.4 We received a number of positive responses from individual consumers to the Consultation, highlighting the consumer demand for such changes. However, it was clear from both the consumer and corporate responses that there remain serious concerns about the state of competition in the retail narrowband market in Hull.
- 1.5 While we share the desire of consumers and companies to improve retail competition in Hull, we consider that the existing restrictions on KCOM bundling have a negative impact on consumer welfare. We consider that the proposed framework for the development of bundled services and prices will allow greater consumer choice while avoiding foreclosure of future competitive entry. In addition we are consulting separately on enhancements to the processes involved in securing wholesale access to KCOM assets which we consider will support future competition.
- 1.6 We therefore confirm that KCOM bundles which conform to the specific conditions set out in this statement should not be considered to be in breach of the ex ante no undue discrimination condition imposed on KCOM in 2009, while obviously KCOM's prices and commercial practices in the retail narrowband market in Hull will remain subject to ex post competition law as KCOM has SMP in this market. This will allow Hull residents to benefit from price reductions and service innovations that can be provided through the bundling of retail services.

Section 2

Background to the Consultation

Fixed Narrowband Retail Services Market Review

- 2.1 On 15 September 2009 Ofcom published a Statement setting out the conclusions of its review of the retail narrowband telephony markets (the “Market Review”), which covered calls and telephone lines (both analogue and digital) for residential consumers and businesses.
- 2.2 We concluded that while most of the UK retail markets, with exception of Hull, were competitive, KCOM retains Significant Market Power (“SMP”) in all retail narrowband markets in the Hull area and that the following retail remedies would be retained:
- No undue discrimination in the pricing and provision of services; and,
 - Price publication for all services
- 2.3 However, we also expressed concern that in the absence of competition, residential and business customers in Hull would not have access to emerging trends in bundled services (specifically narrowband and broadband bundles), allowing both savings at the retail level through the purchase of multiple products and future innovation in service offerings.
- 2.4 We therefore stated our intention to discuss options with KCOM which might allow the development of new bundled services while retaining controls commensurate with the SMP position KCOM continues to hold.

Interpretation of undue discrimination

- 2.5 In the Market Review Ofcom considered the extent to which the current conditions prohibit bundling. It is not explicit in the SMP conditions where non-discrimination is applied, but as noted in earlier reviews, Ofcom’s current stated position is that bundles of SMP and non-SMP services would be likely to be unduly discriminatory¹.
- 2.6 This presumption may be rebutted where certain criteria are met, as set out in the 2003 Pricing of Services for Business Customers Consultation document², in particular where:
- competitors can replicate, technically and commercially, each element of the bundle;
 - the bundled price can pass a net revenue test;
 - eligibility for any level of discount for the overall bundle of services is not dependent on the customer spending a minimum sum on any individual service within the bundle;
 - details of the bundles price or discount scheme are published; and,

¹ For example the Consent on Business Line Replicability, published 29 May 2007

<http://stakeholders.ofcom.org.uk/binaries/consultations/draftconsent/consent.pdf>

² <http://www.ofcom.org.uk/static/archive/oftel/publications/licensing/2003/price1003.pdf>

- the bundled price or discount scheme is made available to all broadly comparable customers.
- 2.7 Our approach to bundles is consistent with the ERG common position on remedies in that specific requirements can be imposed under Article 17(2) of the Universal Service Directive to not unreasonably bundle services.³ However, the common position then goes on to suggest that where such a restriction could rule out “welfare enhancing bundles”, an alternative condition could be imposed that an undertaking be obliged to report proposed new bundles to the NRA who would then judge whether they were anti-competitive.⁴
- 2.8 The consideration of options which balance rules to prevent dominant undertakings distorting competition with the need to ensure that welfare enhancing services are provided, is also consistent with our statutory duties set out in sections 3 and 4 of the Communication Act 2003, in particular Ofcom’s primary duty to further the interests of consumers.

KCOM’s proposal

- 2.9 In the light of the Market Review comments we invited KCOM to submit a proposal for the development of retail bundles which would be consistent with the need to ensure there was no risk to future retail competition.
- 2.10 On 5 August 2010 we published a Consultation which set out our review of KCOM’s proposal and the conditions we considered appropriate for the provision of retail bundles in Hull. The KCOM proposal is set out at Annex A.

Consultation Impact assessment

- 2.11 In the Consultation we recognised that KCOM would be unable to meet the criteria requiring replicability as KCOM does not provide wholesale supply of all of its products. We also considered whether there was evidence to suggest that in the near future there is likely to be the level of competitive entry in Hull that would be likely to lead, in the short term, to supply of bundled services as offered by Communications Providers in other parts of the UK. We considered it likely that Hull consumers could for the immediate future be the only group in the UK unable to access the benefits of such bundles, if the current restrictions on KCOM remained in place.
- 2.12 Given the current lack of competitive entry in the Hull area, we considered whether the proposals set out by KCOM address concerns about potential competitive harm, specifically foreclosure. KCOM proposed to base its retail bundled offerings on its own costs where available, and where not available, on proxy costs based on BT’s wholesale service offerings.
- 2.13 Our assessment of KCOM’s methodology, sources of data and calculation approach is that this represents a reasonable and verifiable approach that provides KCOM with a predictable approach to the pricing of bundles of SMP and non-SMP services that does not appear to foreclose the provision of similar services by other parties. That is the pricing structure proposed would, in our view, allow for a reasonably efficient operator to enter the market and offer competitively priced retail services using KCOM’s wholesale inputs, whilst allowing for a return on the retail price offered.

³ Directive 2002/22 of 7 March 2002 on universal services and users’ rights relating to electronics communications network and services, OJ L 108, 24.4.2002, 51

⁴ http://www.erg.eu.int/doc/meeting/erg_06_33_remedies_common_position_june_06.pdf.

- 2.14 We therefore proposed in the Consultation that the presumption of a breach of the ex ante no undue discrimination SMP condition by KCOM bundling SMP and non-SMP products together would not apply.
- 2.15 It is also important to bear in mind that KCOM's prices and commercial offerings in the retail narrowband market in Hull remain subject to ex post competition law as KCOM has SMP in this market. This means KCOM will be forced to check that its retail offers do not foreclose or "squeeze" rival commercial providers if and when these providers begin offering retail packages competing with KCOM's.

Section 3

Responses to the consultation and Ofcom's determination

Introduction

- 3.1 We received 35 responses to the Consultation, 30 from individuals, one from KCOM and 4 from other Communications Providers. Of the individual respondents 10 requested anonymity and two individuals and one Communications Provider provided fully confidential responses. Organisations that were happy to publish their responses were KCOM Group PLC, MediaSat3 Limited, Nexus Telecommunications, and Talk Talk Group. Responses are available for review on our website.⁵

Consumer responses

- 3.2 The overwhelming majority of individual responses were positive and agreed with our proposal, though a small number of the responses did express concern about the state of competition in the Hull area.
- 3.3 Of the 30 individual responses received, 27 were supportive, 3 disagreed, and some responses expressed concern about: lack of choice of supplier; pricing; and, contract terms.

Ofcom's comments

- 3.4 We welcome the number of responses to the Consultation and in particular the interest from individuals. These responses demonstrate consumer awareness of the potential benefits of competitive markets in telecommunications services in terms of supplier choice, retail prices, and innovation, including the ability to purchase bundled services.
- 3.5 In the absence of competition in the Hull area, the overall majority of consumers who responded welcomed the lifting of restrictions on KCOM and would welcome the opportunity to buy bundled fixed line telephone and broadband packages.
- 3.6 Whilst in our view some of the issues raised are outside the scope of this consultation, which is on the narrow issue of whether we should allow retail bundling by KCOM without presuming it to be in breach of its ex ante no undue discrimination SMP condition we set in 2009, we have commented on these points below.

Lack of choice of supplier

- 3.7 Some individual responses noted the state of competition in the Hull area and the lack of choice of telecommunications provider for residential and business customers. Ofcom agrees that consumers would benefit from competitive markets operating in the Hull area in terms of choice of supplier, downward pressure on retail prices and innovation, including the bundling of services.

⁵ <http://stakeholders.ofcom.org.uk/consultations/retail-bundling-in-hull/?showResponses=true&pageNum=1#responses>

- 3.8 In the absence of competition in retail markets Ofcom has imposed regulations on KCOM in relevant wholesale markets the purpose of which is to enable competitive entry in the Hull area if and when it is deemed profitable by rival Communications Providers, which would ideally lead to the supply of singular and bundled fixed telecommunication and broadband services in line with those available throughout the rest of the UK. Ofcom will encourage and support reasonable attempts by Communication Providers to obtain wholesale access with a view to competing in the downstream fixed telecommunications and broadband markets.

Pricing

- 3.9 KCOM is not currently subject to pricing regulation in the retail markets because when this was looked at in the Market Review, prices were considered to be broadly in line with prices for similar services throughout the UK. KCOM therefore has discretion in the pricing of its retail offerings to consumers in the Hull area.
- 3.10 In this Consultation we did not propose that Ofcom would set or agree prices for retail bundles. It is our expectation that by allowing KCOM to bundle retail products there would be a cost saving that could be passed on to consumers through a reduction in prices for bundled services compared to the purchase of those services on an individual basis. However, in assessing the methodology for pricing those bundled services we have also considered the need to ensure that future competitors are not priced out of the market, and that a sufficient margin is allowed on cost based services to enable competitive entry (while accepting the somewhat theoretical nature of the exercise at present given the absence of actual competitors).

Contract Terms

- 3.11 One respondent suggested that allowing the bundling of retail products would result in KCOM migrating customers onto new contract terms, which would further delay a new entrant's ability to compete because consumers would be tied into a new contract for a minimum period, potentially up to a year. The issue of contract terms is outside the scope of this consultation, but understandably is of concern to consumers.
- 3.12 Contract terms in telecommunications services may be considered by Ofcom under consumer protection legislation. It is not unusual however for telecommunications providers to apply a minimum 12 month contract period, and this is in line with elsewhere in the UK. Given that KCOM has not yet launched bundled services, we are not in a position to anticipate the minimum period applied to any contracts for new or existing customers, or indeed whether existing customers will be required to start a new contract period for bundled services. In any event KCOM has SMP in the supply of retail narrowband services in the Hull market so any contractual terms that foreclosed potential or actual competitors might be regarded as unlawful under the Chapter II provisions of the Competition Act.

Corporate responses

- 3.13 Of the five organisations that responded to the consultation only KCOM unequivocally supported the proposal. Other Communication Providers expressed concerns that the proposal would further reduce the opportunity for competitive entry in the Hull area by further entrenching KCOM's SMP position.
- 3.14 KCOM, in welcoming the proposal to allow it to bundle SMP and non-SMP products, commented on the limited activity of competing Communications Providers in Hull,

especially in terms of supply to residential customers, and commented that there is no evidence to suggest that there would be competitive entry in the near future that would lead to the supply of bundled services of the type that Hull consumers are requesting.

- 3.15 The other Communications Providers highlighted the current absence of existing wholesale narrowband products equivalent to the Openreach Wholesale Line Rental 3 (WLR3) product and Shared Metal Path Facility/Metal Path Facility products known as Local Loop Unbundling (LLU).
- 3.16 MediaSat3 and Nexus suggested that if KCOM is allowed to bundle services then Ofcom should oblige KCOM to provide such wholesale products immediately, and this position was supported by comments from the confidential response.
- 3.17 MediaSat3 and the confidential respondent both stated an interest in entering the retail markets in Hull, but indicated that they were having difficulty in obtaining true wholesale access from KCOM in the absence of a requirement for KCOM to provide WLR3 and LLU.
- 3.18 All the corporate responses, with the exception of KCOM's, expressed concerns that by allowing bundling now, we would allow KCOM to entrench its market position and delay competitive entry and the development of consumer choice in Hull.

Ofcom's comments

- 3.19 Ofcom has, since 2003, established a series of regulations on KCOM through the Market Review process to enable entry in the wholesale access markets with a view to encouraging entry in the downstream retail markets. Whilst the same access obligations imposed on BT in the same time period has led to entry and competitive retail markets operating in other parts of the UK, there has been little or no significant entry in the Hull area, meaning that Hull consumers have missed out on the benefits of retail competition.
- 3.20 KCOM is currently subject to clear obligations to provide network access and the requirement not to discriminate unduly, which means it must respond to requests for access in good faith. In addition KCOM is subject to a Basis of Charges obligation which requires it to base wholesale prices on the costs of providing those services.
- 3.21 Obligations requiring transparency are also in place to ensure KCOM is complying with the obligations to provide network access and the requirement not to discriminate unduly. These transparency obligations provide third parties with access to the information they need in order to make informed decisions about purchasing KCOM's wholesale products. Without these obligations, not only would it be difficult for third parties to assess whether KCOM was meeting its obligations to provide network access and to not discriminate unduly, third parties may not have sufficient information in order to decide whether, or how, to enter the downstream market by purchasing KCOM's wholesale products.
- 3.22 In addition the WLA Market Review statement published on 7 October 2010 also imposes a revised SOR process for the development of wholesale sale access products in the local access markets (Covering LLU).
- 3.23 Ofcom is shortly due to publish the wholesale fixed analogue exchange lines market review consultation document ("WAEL Market Review Consultation"). Wholesale fixed analogue exchange lines are a key input to the fixed telephone services that are

provided to the majority of residential and business consumers. In the WAEL Market Review Consultation we are considering proposals to refrain from requiring KCOM to establish wholesale narrowband products in advance of evidence of clear demand because of concerns about the disproportionate cost impact.

- 3.24 We accept that there have been structural issues with the negotiation of wholesale access in Hull and in the WAEL Market Review Consultation we are considering proposing a new SMP condition on KCOM requiring an improved Statement of Requirements ("SOR") process for the development of wholesale products. This requirement on KCOM to provide an SOR process to support requests for network access will provide prospective competitors with information on the form, timing and processes associated with wholesale product development that will assist operational and strategic decision making.
- 3.25 We are also aware that that the additional effort required to negotiate wholesale access, given the relatively small size of the market, has meant that the major retail Communication Providers have given Hull a low priority compared to other areas of the UK. Ofcom notes that despite its response, Talk Talk Group has not indicated that it was intending to enter the retail markets in Hull, and, our understanding is that it is unlikely to do so in the near future.
- 3.26 We welcome the responses to this Consultation from smaller Communication Providers which suggest that there is a willingness to enter into the Hull retail markets at a local level, if appropriate wholesale products are made available i.e. WLR and LLU.
- 3.27 MediaSat3 has been in contact with us and confirmed that it is seeking to obtain wholesale products from KCOM that would enable it to offer retail services to both residential and business customers. MediaSat3 has indicated that it can demonstrate clear demand, and as far as Ofcom is aware, is currently in the process of negotiating with KCOM. As we have indicated to MediaSat3 and other interested stakeholders we are willing to engage with any party to ensure that access requests are properly dealt with. Ofcom has Guidelines for the handling of disputes and complaints⁶ and these guidelines should be referred to in the event that commercial negotiations fail or there is evidence that KCOM is not currently fulfilling its regulatory obligations to provide wholesale access on reasonable request.
- 3.28 Notwithstanding this interest it is likely to be some time before there is a level of effective competition to KCOM in Hull that could substantially affect the range of retail packages available to end users in the Hull area. Our concern is to ensure that, while ensuring appropriate incentives for competitive entry, Hull residents are not blocked from access to services unnecessarily, particularly where there is a clear demand for such services and they are clearly welfare-enhancing.
- 3.29 In addition, as noted earlier, that KCOM's prices and commercial practices in the retail market remain subject to ex post competition law to ensure there is no foreclosure of potential (and actual) competitors.

⁶ Guidelines for the handling of competition complaints, and complaints and disputes about breaches of conditions imposed under EU Directives can be found at:
<http://stakeholders.ofcom.org.uk/binaries/enforcement/competition-bulletins/other/guidelines.pdf>

Conclusions

- 3.30 After consideration of all 35 responses, and taking into account our duties to balance the needs of consumers with the protection of competition, we have concluded that that the proposal set out in the Consultation remains appropriate. To ensure that consumers in the Hull area are able to secure near-term access to the types of bundles services available throughout the rest of the country, we will allow KCOM to offer bundles of SMP and non-SMP services.
- 3.31 Notwithstanding the issues raised about access to wholesale products, we consider that the concerns about the impact on consumers of existing restrictions on bundling remain real and pressing.
- 3.32 As noted in the ERG common position, we should not rule out welfare enhancing bundles especially in a context where KCOM faces limited or no actual competition at the retail level. The responses to the Consultation offer no evidence that the construction of bundles in accordance with the framework proposed would foreclose competitive entry.
- 3.33 This is subject to a requirement that the pricing of bundles adheres to the formula KCOM has proposed which we consider will allow a margin for a competitor to enter the market. Annex 1 sets out the algorithm proposed for setting bundled prices which relies on the costs of existing wholesale products either provided by KCOM, or proxy costs of BT's wholesale products, where the equivalent products are not currently provided by KCOM. In the event that KCOM extends its range of wholesale products we will require them to be incorporated in the algorithm such that the costs included in the calculation represent those experienced by competitors. KCOM will in any event need to check that any new wholesale or retail prices introduced in these SMP markets comply with ex post competition law.
- 3.34 In reaching this position we have considered how to balance the desire of consumers to access bundled services, which is evidenced by the individual responses to this Consultation, against the need for us to protect the opportunity for competitive entry.
- 3.35 Ofcom policy is designed to encourage competitive entry in the Hull area, and we welcome the interest of the stakeholders that are seeking wholesale access from KCOM in order to compete in the retail markets for fixed telecommunications and broadband services. We consider we have put in place, through the Market Review SMP obligations imposed upon KCOM by Ofcom at the wholesale level, processes to allow entry and we support Communications Providers in negotiations with KCOM.
- 3.36 In the event that KCOM is not responding appropriately to reasonable demand for wholesale products, we will look at any evidence presented to us formally or informally. To date no such evidence has been presented to us, and as noted above, we are in the process of engaging with MediaSat3 and another confidential respondent to ensure that any concerns around access to wholesale services are addressed appropriately. Again as noted Ofcom provides a resolution process for disputes in the event that Communications Providers consider KCOM is not fulfilling its obligations.
- 3.37 We will continue to monitor the state of competition in the Hull area and address the concerns surrounding the lack of competitive entry through the regulatory mechanisms available to us.

- 3.38 We consider, therefore, that our proposed framework for allowing bundles in Hull should stand. Restrictions on bundling will be removed provided that:
- bundles are made available to all residents and businesses in the Hull area;
 - prices for bundles are published on KC's website; and
 - prices are set in a way that will not discourage other communications providers from offering services to consumers in Hull, should they wish to do so.
- 3.39 Therefore, we consider that where KCOM provides bundles of SMP and non-SMP services in accordance with the framework set out in the Consultation and confirmed by this Statement, the presumption of undue discrimination should not apply. We are satisfied that allowing KCOM to bundle SMP and non-SMP services in Hull in this way, combined with the measures being proposed for encouraging competitors to enter the relevant market and the ex post safeguards already in place, will further the interests of consumers in Hull and ensure any future potential competition is protected, in line with our statutory duties as set out in sections 3 and 4 Communications Act 2003.

Annex 1

KCOM proposal

See Annex 4 & 5 on website <http://stakeholders.ofcom.org.uk/consultations/retail-bundling-in-hull/>