Fixed Narrowband Retail Services Markets

Consultation on the identification of markets and determination of market power

Consultation

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Contents

Section 1

Summary

Introduction

1.1 This review considers the state of competition in the retail narrowband telephony markets, that is, analogue and digital (ISDN) telephone lines and calls for consumers and businesses. Our aim is to determine whether there is effective competition in these markets and, if not, how best to regulate the behaviour of any companies that we find have significant market power ("SMP" - in other words, companies that have the power to behave sufficiently independently in a market in a way which could be to the detriment of consumers).

1.2 We are proposing that the UK retail markets, with the exception of Hull, are now largely competitive. This is a significant milestone in the history of Ofcom. For the first time since the creation of Ofcom's predecessor, Oftel, we are proposing to remove all company specific retail regulations on BT intended to enhance competition in analogue telephony. This is due to increased competition in these markets, which, we believe, is a direct result of the changes to the regulation of BT's wholesale services due to our Telecommunications Strategic Review ("TSR")[1]. The main effect will be to increase competition in these retail markets by allowing BT to freely bundle fixed narrowband products with broadband and TV services.

1.3 Our proposals do not affect the Universal Service Order ("USO") regulations which ensure that BT offers a universal service at a uniform price. Equally, Ofcom will continue to regulate the retail activities of BT, on an equal basis with other Communications Providers, through sector regulations[2]. We will continue to monitor consumers' experience of these services and will intervene if appropriate.

Background

1.4 When we last reviewed these market in 2003[3], we found that BT (UK excluding Hull) and Kingston Communications (in Hull)[4] had SMP in almost all the fixed narrowband retail services markets[5]. We decided regulations were essential to ensure that BT and Kingston could not use their SMP to the disadvantage of other Communications Providers, consumers or both. As a result we set retail controls for BT and KCOM.

1.5 Since the 2003 review, Ofcom has concentrated on measures to enhance competition in the retail markets. The aim being encouraging real competition for the benefit of consumers and businesses, and a reduction in BT and KCOM's market power.

1.6 In the 2005 TSR, Ofcom set out seven principles for the regulation of telecoms markets, including that Ofcom should:

- focus regulation on the deepest levels of infrastructure where competition will be effective and sustainable;

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[1] http://www.ofcom.org.uk/consult/condocs/telecoms_p2/statement/main.pdf.
[2] Communications Act general conditions and general consumer protection legislation / regulations,
[3] http://www.ofcom.org.uk/static/archive/oftel/publications/eu_directives/2003/fix_narrow_retail0803.pdf
[4] Kingston Communications is now operating as KCOM Ltd, though trades in Hull as Kingston Communications
[5] The exception was BT was not found to have SMP for international business calls

- ensure equality of access at those levels; and
- as soon as competitive conditions allow, withdraw from regulation at other levels.

1.7 The key outcomes of the TSR, were the Undertakings by BT[6], the creation of Openreach (the functional separate organisation within BT providing wholesale access services) and the development of equivalence of inputs for both BT and other Communications Providers in the delivery of services to households and businesses.

1.8 As a result of these developments and the improved state of competition they supported, we decided to remove the retail price controls on BT in 2006[7]. The following year, we relaxed retail access remedies for businesses with telecoms spend over £1M pa on the basis other Communications Providers could compete with BT on an equal footing using wholesale line rental ("WLR").[8]

Our proposals

1.9 Our assessment of the current state of competition in the retail market confirms the trends we have seen since the last review. There is compelling evidence that most of these markets are now competitive. For example, in the residential market, 14 new retail narrowband providers have entered the market since 2005 (12 based on WLR plus two based on full LLU). BT market share has been reduced substantially. In residential access this is now 66%, and in business at 57% market share. While we recognise that BT still has a relatively high residential market share, we expect this to fall substantially further over the review period.

1.10 Our analysis suggests that BT (in the UK excluding Hull) no longer has SMP in:

- retail fixed narrowband telephone lines for business and residential consumers;
- retail fixed narrowband calls for business and residential consumers.

1.11 We think this finding and the consequent removal of remaining SMP regulations will have a positive effect on residential consumers and businesses. We expect increased competition for the provision of retail telephony services from BT, since BT will be able to bundle these services with other services, e.g. broadband.

1.12 We are aware of the risk that customers that are uninterested in changing providers are most likely remain with BT. However, we consider that BT could not readily exploit this fact as these consumers are not confined to one specific social, economic or demographic group. Also changes to SMP status and remedies have no impact on BT's universal service obligations which ensure universal access and the protection of vulnerable consumers.[9]

1.13 While we consider that BT still has SMP in ISDN2 and ISDN30 lines we think that the current retail remedies are no longer effective and are even potentially

[6] http://www.ofcom.org.uk/consult/condocs/statement_tsr/
[7] http://www.ofcom.org.uk/consult/condocs/retail/prc.pdf.
[8] Wholesale line rental ("WLR") is a regulated wholesale service provided by BT which allows other communications providers to offer telephone line access
[9]We will shortly reviewing of the current USO. We intend to consider whether changes to it are required. We will include an assessment of the extent to which the USO results in a significant net burden upon BT and KCOM, the universal service providers, and the case for alternative funding and procurement models to ensure that USO provision is both effective and proportionate

counterproductive in the development of enhanced competition. We consider that it is preferable to rely solely on the proposed wholesale remedies for those markets.

1.14 We have reviewed the retail markets in Hull. We have found no significant change in KCOM’s position, so we conclude that KCOM retains SMP in all retail narrowband markets.

Section 2

Purpose and structure of the review

Introduction

2.1 This review is part of the second round of market reviews to consider the state of competition in retail narrowband markets. The objective of the review is to:

- determine the structure of the retail narrowband markets;
- assess whether any individual company or, if appropriate, set of companies, hold significant market power in any of those markets; and if significant market power is found
- determine what *ex ante* remedies are appropriate to address the market power; enhance competition in the markets and protect consumers from the exploitation of the market power.

2.2 In particular, this review will reconsider the set of retail markets defined in the first round of market reviews in 2003 and will, as part of the analysis, consider the impact of changes to the remedies that have been made since that review (particularly the removal of the retail price controls).

2.3 We are required to undertake the Market Review as part of our commitment to a regular programme of such reviews. However, other factors support the review at this time:

- Changes to the EC recommendations have removed the fixed calls market from the list of markets suitable for *ex ante* regulation, calling into question our continued determination in this market. (However, we are required by the Communication Communications Act 2003 ("the Communications Act") to re-review any market in which we have previously found SMP.);
- Changes to wholesale regulations undertaken in response to the TSR;
- Indications of increased competition to fixed networks from mobile; and
- Changes to the nature of telecommunications sales at fixed locations, large number of new market entrants and new sales strategies e.g. bundling

Background – Previous reviews and strategic framework

2003 Market Review

2.4 In 2003 Oftel completed the first round of market reviews linked to the European Commission directives on fixed narrowband markets potentially subject to *ex ante* regulation which included the Fixed Narrowband Retail Services Market Review[10].

2.5 The outcome of this review was a series of Significant Market Power (SMP) determinations for BT and Kingston, in which SMP was found for:

[10] http://www.ofcom.org.uk/static/archive/oftel/publications/eu_directives/2003/fix_narrow_retail0803.pdf

- Nine out of 10 identified retail calls markets (with the exception of business international calls for BT) (see list of previous markets and proposed new markets in the presentation) and
- All narrowband retail access markets (residential and business analogue markets, ISDN2 residential and business and ISDN30 business)

2.6 This determination in turn lead to remedies which included (initially):

- The standard remedies of no undue discrimination and price publication on all SMP services;
- Retail price controls (RPCs) with a proposed review in 2006; and
- Regulatory account reports on the services covered by the RPCs.

Telecommunications Strategic Review and withdrawal of the RPCs

2.7 In the TSR, Ofcom set out seven principles for the regulation of telecoms markets, including that Ofcom should:

- focus regulation on the deepest levels of infrastructure where competition will be effective and sustainable;
- ensure equality of access at those levels; and
- as soon as competitive conditions allow, withdraw from regulation at other levels.

2.8 The subsequent Undertakings by BT, creation of Openreach, Equivalence of Input ("EOI") development and the creation of a commercially viable WLR product by BT, provided us with two opportunities to consider the extent of regulation in the light of improved regulation at the deepest level of infrastructure:

- This first opportunity was the 2006 review of the RPCs[11]. The RPCs were allowed to lapse on the basis that there was now sufficient retail competition, due to the improvement in the wholesale environment, to ensure prices were set at an efficient level. The removal was accompanied by a commitment by us to a review of the removal of controls which we are undertaking as part of this Market Review.
- The second was the 2007 Replicability decision. This allowed controlled exceptions to SMP retail access remedies for larger businesses (telecoms spend over £1M pa) on the basis that the WLR product was fit for purpose and would allow other Communications Providers to fully compete. The stated intention in this review was that the £1M pa limit was a temporary restriction and that, if it were successful, Ofcom could extend this exemption to cover all business customers. We have had no issues raised by Communications Providers or businesses with respect to these changes. If we were not undertaking this Market Review at this time, we would consider extending the exceptions to smaller businesses and to the calls market.

[11] http://www.ofcom.org.uk/consult/condocs/retail/prc.pdf.

Relationship with the Fixed Narrowband Wholesale Service Market Review and other Related Projects

2.9 In considering market analysis there is a clear relationship between any analysis of retail markets and their supporting wholesale markets. Ultimately, wholesale markets are defined in terms of the retail markets they support. However, equally importantly, analysis of forward looking retail markets competition depends on a set of assumptions on the structure of the wholesale markets available to competitors in the retail sector.

2.10 In recognition of this relationship, we are simultaneously undertaking our review of the state of competition in the Fixed Narrowband retail and wholesale services markets. In forming our conclusions and recommendations each review is informed by the conclusions and recommendations of the other. In the case of this retail review, we assume that the wholesale recommendations ensuring the continued provision of appropriate wholesale access and call origination markets are in place and that, at the very least, the existing level support for competition provided by the wholesale regulations is sustained. The review also assumes all other existing regulations from other related markets (for example, the Wholesale Local Access market review and its local loop unbundling (LLU) remedies) are sustained.

2.11 The Fixed Narrowband Wholesale Services Market Review is considering:

- the wholesale narrowband access;
- call origination and termination; and
- conveyance and transit markets.

2.12 Other related projects include:

- The Network Charge Control: This is considering any charge control remedies for network conveyance and transit and call origination and termination required by the Fixed Narrowband Wholesale Services Market Review. We are consulting on the NCC simultaneously with the Narrowband Market Reviews.
- Openreach Price Framework: This is considering the charge controls for LLU and WLR.

The Regulatory Framework

2.13 The regulatory framework that applies to the issues covered in this document is discussed in detail at Annex 7. The Framework is based upon five EU Communication Directives, four of which were implemented into UK law by the Communications Act. The fifth directive was implemented by regulation on 11 December 2003.

2.14 The Communications Act sets out, at section 3, general duties of Ofcom where we must, in carrying our functions, further the interests of citizens in relation to communications matters and the interests of consumers in relevant markets, where appropriate by promoting competition.

2.15 Section 4 of the Communications Act sets out duties of Ofcom for the purpose of fulfilling Community obligations.

2.16 Sections 3 and 4 apply across our decision making in this document as we carry out the function of undertaking a market review.

2.17 The framework, as implemented by the Communications Act, sets out the procedure to be followed when undertaking market reviews. In particular section 84 of the Communications Act requires us to carry out further analyses of identified markets at appropriate intervals. Paragraphs 2.4 to 2.8 above set out the previous decision and reviews relevant to this market and, taking into account the Commission's 2007 review and revision of its Recommendation on relevant product and service markets ("the Recommendation"), we consider it appropriate to conduct a review of narrowband retail services.

2.18 A market review normally has three stages:

- Market definition, i.e. the definition of relevant markets;
- Market analysis, i.e. the assessment of competition in each market; in particular whether any undertaking have SMP in a given market; and
- Remedies, i.e. the assessment of appropriate regulatory obligations where there has been a finding of SMP.

Market Definition

2.19 The legal process set out in the legislation on the market definition stage is considered in detail in Annex 7. In considering market definitions we have had regard to the Commission's Recommendation. The Recommendation identifies markets that may be susceptible to *ex ante* regulation. On the last review of the Recommendation in 2007, the Commission identified only one market at the retail level as being susceptible to *ex ante* regulation; access to the public telephone network at a fixed location. Although the Commission has identified that single retail market in its Recommendation, this does not mean that NRAs are not in a position after analysis of relevant markets to, where a finding of SMP is made, impose regulatory remedies on those markets should national circumstances justify it. Equally, if on analysis of the identified market in the Recommendation, an NRA finds that the market is competitive, based upon national circumstances, it would not be appropriate to impose regulatory remedies.

2.20 The Recommendation is discussed in Annex 7 and, in particular, the use of the "three criteria test" is considered. Where a market outside of the list identified by the Commission is considered by an NRA, the Recommendation states that the three criteria test should be applied cumulatively to determine if the market is susceptible to *ex ante* regulation. The three criteria are:

- Barriers to entry and the development of competition;
- Dynamic aspects - no tendency toward competition; and
- Relative efficiency of competition law and complementary *ex ante* regulation.

2.21 We have taken the Recommendation into account when identifying markets in this review.

Market Analysis: the criteria for assessing SMP

2.22 The legal process set out in the legislation on the market analysis stage is considered in detail in Annex 7. In considering market analysis we have taken into account both the Commission guidelines (Guidelines for market analysis and the assessment of SMP) and guidance produced by Oftel in relation to the criteria to assess effective competition.

2.23 The SMP guidelines require NRAs to assess whether the competition in a market is effective (i.e. no operator is found individually or jointly dominant). This is undertaken through a forward looking evaluation of the market, determining whether the market is prospectively competitive, taking account of foreseeable developments.

2.24 Market share is an indicator of market power and the SMP Guidelines state that, in the Commission's practice, single dominance normally arises where market shares are over 40%, and very large market shares of over 50% are evidence of the existence of a dominant position. This presumption is rebuttable and it is stressed in the guidelines that the existence of a dominant position cannot be established on the sole basis of large market shares, and that a thorough and overall analysis is required before coming to a conclusion on the existence of SMP. Non-exhaustive criteria are suggested to measure the power of a market undertaking. The relevant section from the Guidelines is set out in Annex 7.

2.25 Where a market is found to be competitive then no SMP conditions can be imposed. Section 84(4) of the Communications 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.

Remedies

2.26 The legal process set out in the legislation on the remedies stage is considered in detail in Annex 7.

2.27 Before considering remedies it is also important to consider whether competition law remedies are sufficient to address the identified problems.

2.28 Where remedies are proposed they have to comply with section 47(2) of the Communications Act, in that they have to be objectively justifiable, not unduly discriminatory, proportionate and transparent.

2.29 In addition section 91(2) requires that SMP conditions being considered at the retail level may only be imposed where conditions at the wholesale level do not allow us to fully perform our section 4 duties in the relevant market.

2.30 When considering appropriate remedies we have also taken account of guidance produced by the European Regulators Group (ERG) remedies; "The Common Position on Remedies".

Section 3

Market and regulatory developments

Introduction

3.1 This section sets out the developments, since 2003, in the retail and wholesale markets that underpin the analysis in the later sections. In particular, we consider the impact of the Telecommunications Strategic Review, the improvement in wholesale services and equality of input ("EOI")[12] and the changes to the market from bundling[13] and increased mobile use. This will be a broad introduction to these trends which will be considered in more detail later.

3.2 We will also consider the changes to retail SMP regulation since the last market review, specifically the removal of retail price controls and the Replicability decision.

Recent market developments

3.3 The 2003 market reviews described a market where the retail narrowband markets in the UK were still dominated by the incumbents (BT and KCOM). While the use of carrier selection / indirect access[14] ("CS/IA") and carrier preselection ("CPS")[15] had led to some competition in the calls markets, access to narrowband fixed lines in most of the country was overwhelmingly dominated by BT (around 80% for residential and business lines – the main challenger at that time being the cable companies with their narrower geographic spread[16]).

3.4 The TSR and the subsequent Undertakings by BT led to a transformation of the competitive environment. We oversaw the creation of Openreach, provision of wholesale services on an equivalence of input basis and the development of fit for purpose wholesale products (wholesale line rental, and local loop unbundling).

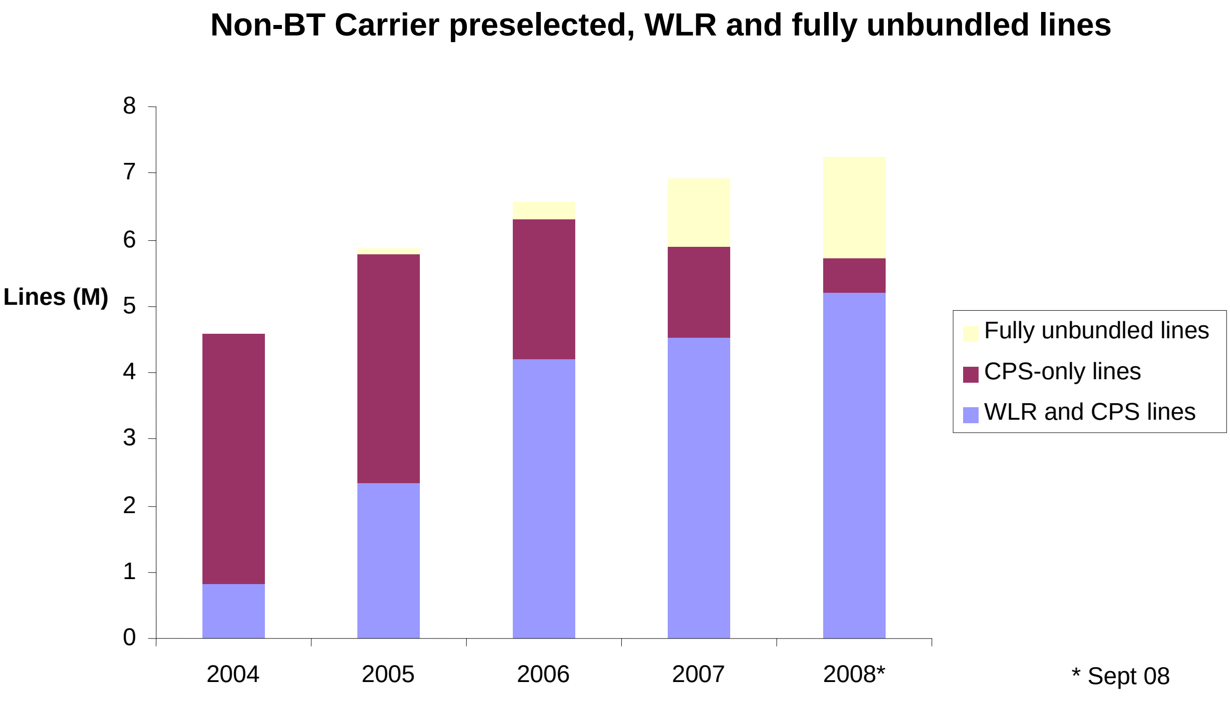
3.5 We have subsequently seen a transformation in the competitive environment – for example in the residential market 14 new retail access providers (12 using WLR, two using LLU) and consequential impacts on service diversity, price and the market share of BT. In the business market we have also seen many additional smaller Communications Providers offering bespoke services.

3.6 For example, prior to 2004 CPS was the only real competitive narrowband option aside from cable. As figure 3.1 shows there has been a massive increase in access services

[12] Equality of Input is a requirement on BT to provided certain wholesale services on an equal basis to both itself and other Communications Providers
[13] We define bundling in this paper as retail telecommunications service packages which include more that one service type (e.g. narrowband, broadband, television, mobile) at a charge less than the component services would be sold individually.
[14] Carrier selection and Indirect Access are synonymous. In the UK the term IA is commonly used, though the Directives and European Commission documentation use CS. We are using both terms for clarity. CS/IA is a service which allows a user to select the routing of calls through a different provider than their default call provider through the use of either a number prefix or automated calling box.
[15] Carrier preselection allows a retail consumer to permanently select an alternative call supplier, rather than the default call provider, for either all calls or specific call types (for example, international calls).
[16] The main cable companies were Telewest and NTL who in 2006 merged to form Virgin Media.

provided by Communications Providers other than BT, with the trend towards the provision of a complete access package (either WLR + CPS[17] or full LLU).

Figure 3.1



Source: Ofcom / operators

3.7 Competition has also led to real savings for consumers. Despite the removal of the retail price controls (discussed below and in Annex 6) we have seen a steady decline in the real cost of narrowband services (see figure 3.2) on a comparable basis.

Figure 3.2

Source: Ofcom / operators

3.8 We have also seen a movement to narrowband services being only one component of a bundle of telecommunications services (see figure 3.3) with both benefits in terms of price and convenience to consumers.

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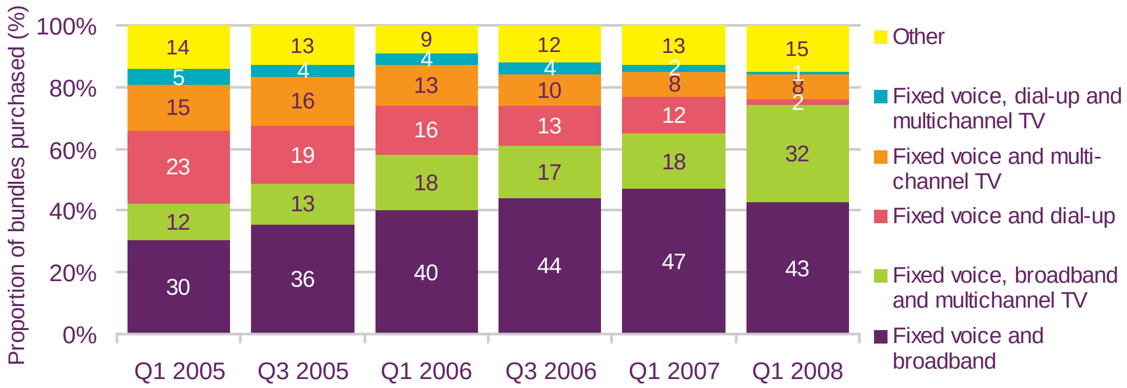
[17] We refer to CPS as a general wholesale service for the provision of calls – in reality Communications Providers chose between CPS and the alternative BT managed service of BT wholesale calls.

3.9 Consumers and business are now able to leverage their use of fixed lines services for access to services like broadband and television, at reduced rates (or at times no additional cost). In addition, consumers have seen innovation in packaging of calls and access with the benefits of predictable monthly budgets and, when chosen correctly, real cost reductions. We discuss the impact of bundling in more detail in section 4.

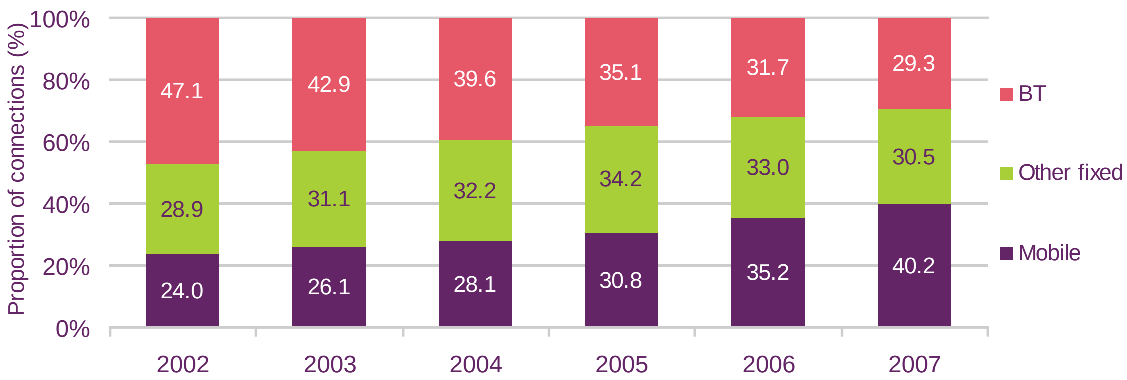
Figure 3.3: Bundled services purchased by consumer by type



Source: Ofcom / operators

3.10 We have also seen the rise of mobile in terms of its percentage of call minutes and revenue (see figure 3.4). While, as this review will argue in section 4, we do not yet consider that mobile and fixed narrowband services are in the same market, it is clear that competition from mobile operators act as a constraint on the fixed markets and has strongly influenced the nature of the service packages provided.

Figure 3.4: Share of total outbound voice call volumes



Source: Ofcom / operators

3.11 The narrowband markets have substantially transformed since the 2003 review. As we will propose in later sections, we consider that this transformation has, excluding Hull, largely led to a position where the market power of the incumbent in the retail markets is sufficiently diminished that the case of *ex ante* intervention in those markets has been substantially reduced.

Impact of removal of the RPCs

3.12 In 2003, following the first retail narrowband market reviews, Oftel confirmed the continuation of retail price controls ("RPCs") on BT as a remedy for the residential market[18]. The RPCs were weighted so that compliance was judged against the charges experienced by the bottom eight deciles (by expenditure) of residential customers. In expectation of improvements in retail competition the control included an opportunity to review the remedies in 2006 to determine whether its continuation was required.

3.13 This 2006 review concluded that the improvements in the competitive environment for retail services (following the introduction of increased use of WLR in particular) allowed us to deregulate the controls on residential charges and the RPC was allowed to lapse. However, the review did call for a subsequent analysis of the impact of the removal. We have undertaken this analysis as set out in Annex 6.

3.14 At the time that they were discontinued, the RPCs effectively held average real (volume change excluded) increases in retail prices to zero (i.e. RPI+0%) for consumers in the bottom eight deciles of expenditure. The RPCs did not include the charge for payment by means other that direct debit.

3.15 Our analysis shows that in nominal terms BT prices for the bottom eight deciles has fallen if the additional charge for non-direct debit is excluded and risen by 2.2% if the non-direct debit charge is included. This is in a period of inflation of around 4% - thus a reduction in real terms.

3.16 Further analysis shows that consumers in the bottom three deciles have experienced greater price reductions with a net reduction of 3.5% (nominal) if the non-direct debit charge is excluded and an increase of only 0.2% if the charge is included. This is approximately a reduction of around 7% in real terms excluding the non-direct debit charges and around 3.8% if it was included.

3.17 On this basis we consider that that removal has had no negative impact on the market and consumer outcomes and may have led to more flexible pricing structures.

Replicability

3.18 The principle of reliance on wholesale remedies set out in the TSR was also the basis for Ofcom relaxing other retail remedies, this time for business customers. Ofcom had been asked by business customers, as well as BT itself, to allow BT to respond to the demands of individual business customers by offering unpublished bespoke prices for services in business retail markets. The requirement to publish charges under the SMP services condition prevented this. Publication of prices can, also, lead to price following, which is unlikely to be in the interests of consumers.

3.19 Equally, Ofcom’s current interpretation of the no undue discrimination SMP services condition is that bundling of SMP and non-SMP products would be likely to be unduly discriminatory, meaning that BT’s ability to tailor packages is limited. Restrictions in bundling can, in some circumstances reduce competition in retail markets (we will consider this point again in Section 6 on remedies for ISDN services).

3.20 Ofcom recognised these potential weaknesses and accepted that, once wholesale inputs were of sufficient standard to enable other Communications Providers to offer retail services that were commercially and technically replicable to those that BT might offer, SMP services conditions could be disapplied for certain customer types. Additionally, Ofcom stated that, in these circumstances, it would no longer presume that bundles of SMP and non-SMP products were likely to be unduly discriminatory under the no undue discrimination SMP services condition.

[18] This was to be the last in a series of such retail price controls going back to 1984.

3.21 On 12 April 2006, Ofcom published the statement entitled *The replicability of BT's regulated retail business services and the regulation of business retail markets*[19] in which it stated that, should BT address certain specific deficiencies with wholesale line rental (WLR), carrier pre-selection (CPS) and low bandwidth leased lines, Ofcom would consent to the non-application of the SMP services conditions. To begin with, Ofcom explained that the consent would be limited to offers made to customers with an annual spend with BT in excess of £1 million per year on a projected basis (assessed on the basis of anticipated spend in the next 12 months consequent on BT being awarded the contract for which it would be bidding). These customers are subject to close account management by senior BT staff and, therefore, it can be expected that BT would be better equipped to ensure that the company did not contravene competition law rules and behave anti-competitively.

3.22 In the event, BT submitted that the deficiencies relating to the WLR product had been sufficiently resolved so as to allow the replication of their retail services. Following a consultation, Ofcom disapplied the remedies related to the retail business access for the larger companies in May 2007. In that statement it was noted that, subject to the monitoring of behaviour in time, the exemption could be extended to smaller companies.

3.23 We have had no cause to find BT has breached the conditions set for the non-application of the access remedies. In fact, were we not undertaking this review we would be considering a further review of replicability which might include an extension of the non-application to smaller companies and the inclusion of calls remedies (as the CPS product now appears to fulfil the criteria for fit for purpose).

3.24 Given the lack of complaints, it would appear that the market for business services has not been unduly disrupted by the exemptions to the remedies. We consider that this is indicative of the current level of competitiveness and the effectiveness of the wholesale remedies.

3.25 We consider the retail narrowband market conditions in more detail in sections 4 and 5 and supporting annexes. However it is clear, from the description above, that there has been substantial changes in those markets which have, in turn, directly benefited consumers and business customers.

3.26 BT appears to have been constrained in its ability to set prices by competition rather than regulation and it has been able to operate under a less restrictive regulatory regime without apparent ill effect on the competitive environment.

3.27 We also note, from the analysis conducted in the Replicability review that there are limits to the effectiveness of retail regulations, which can act, in some circumstances, to the detriments of competition. We consider that this point offers some guidance to our proposed approach to the ISDN markets discussed in section 6.

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[19] http://www.ofcom.org.uk/consult/condocs/draftconsent/statement/

Section 4

Market definitions

4.1 Market definition is an important intermediary step in the assessment of whether a firm has significant market power (SMP). It allows us to consider the competitive constraints imposed by demand and supply-side substitutes as well as to compute market shares.

4.2 In defining the relevant markets we follow our standard approach which fully takes into account the relevant guidelines and recommendations published by the Commission. Under this approach relevant product and geographic markets are identified by using the "hypothetical monopolist test". A product is considered to constitute a separate economic market if it would be profitable for a hypothetical monopoly supplier of the product to impose a "small but significant non-transitory increase in price" (SSNIP) above the competitive level. If a hypothetical price rise would not be profitable then the market definition should be expanded to include substitute (either demand or supply-side) products.

4.3 It may also be appropriate for products not linked by demand or supply-side substitution to be placed in the same economic market if the conditions in their supply or demand are sufficiently homogeneous. For example, where consumers buy a basket or bundle of goods and the overall focus of competition is on the price of the bundle as opposed to the prices of its constituent elements, then a bundle market definition may be appropriate even although the individual elements of the bundles may not be substitutes.

4.4 However, market definition is not an end in itself, and we believe that there are risks in putting too much emphasis on an assessment of where the boundaries of the relevant economic market might lie. For example, the evidence points to increasing substitution between fixed and mobile access and calls. However, what matters for an assessment of SMP is not so much whether mobile lies just "inside" or just "outside" the market but rather the constraint it imposes on the price of fixed access and calls.

4.5 A slightly different issue is whether we should include products such as access and calls - which are largely complements[20] - in the same or in separate economic markets. The classical way of defining an economic market, the SSNIP test, provides only limited guidance as to when products are sufficiently complementary to be included in the same market. The constraint that the price of access imposes on the demand for calls (and vice versa) can however be more fully considered in a SMP assessment.

4.6 On account of these and other issues we have chosen to adopt a largely pragmatic approach to market definition. Specifically, where the evidence of substitutability is conclusive we have chosen to amend our previous market definitions, but where the evidence is ambiguous we have chosen to retain our previous market definitions while recognising any increased competitive constraint from greater substitutability in our SMP assessment.

4.7 In the assessment below we summarise the evidence as it relates to the key market definition questions and provide our conclusions on where we consider the boundaries of the relevant economic market to be.

[20] Access and calls are complements in the sense that both access and calls need to be purchased in order to make a voice call. They may also be economic complements if an increase in the price of access reduces the demand for calls (and vice versa).

Summary of conclusions

4.8 This sections concludes that there remain distinct national retail fixed narrowband access and calls markets.

4.9 While there are clear indications that there is increased fixed mobile substitution and that bundles of telecommunications products are increasingly being considered as a single purchase, consumers and businesses still make purchasing choices based around the traditional fixed narrowband services.

4.10 The key differences from the market definitions of 2003 are:

- the reductions in the number of calls markets (from individual markets for different calls types – e.g. local, national, international etc to a single calls market and
  - - in 2003 there was competition in specific calls types via carrier pre-selection. While this continues to a limited extent we no longer consider that purchasing decisions in the market operate in this manner.
- the removal of the ISDN2 residential market
  - - This market has been replaced by residential broadband.

4.11 Specifically we have consider that the fixed narrowband markets are

- For UK (excluding Hull)
  - Residential Fixed Narrowband Analogue Access;
  - Business Fixed Narrowband Analogue Access;
  - Residential Fixed Narrowband Calls;
  - Business Fixed Narrowband Calls;
  - ISDN2 Access; and
  - ISDN30 Access.
- For Hull
  - Residential Fixed Narrowband Analogue Access;
  - Business Fixed Narrowband Analogue Access;
  - Residential Fixed Narrowband Calls;
  - Business Fixed Narrowband Calls;
  - ISDN2 Access; and
  - ISDN30 Access.

Business and residential segment are separate markets

4.12 An SME is free to choose between a business and a residential tariff. However, CPs are able to discriminate between business and residential customers to a considerable extent through offering packages which separately target business and residential customers.

4.13 For example, BT's Business Plan offers SME's more rapid installation of the phone line, an entry into the business section of the phone book, added features such as call waiting/diversion, and a range of call tariffs that are attractive to many business customers (discounts for high volumes, capped call prices, and low peak prices). In contrast, residential tariffs typically provide a more limited range of value-added services and offer low priced off-peak calls (including free minutes).

4.14 The differences between business and residential packages are also reflected in fixed line access prices. For example, BT's minimum price of access is £10.27 for a residential customer and £16.21 for a business customer.

Table 4.1 BT Residential and Business Tariffs

	BT Business Plan	Unlimited Evening and Week-end Plan (Residential)	BT Anytime + International saver (Residential)
Access Price	£16.21* -£17.10**	£10.27	£16.10
Geographic landline (off-peak)	Capped at 10p/hour	Free	Free
Geographic landline (peak)	Capped at 10p/hour	235p/hour	Free
Calls to UK mobiles	25p/hour	734p/hour	440p/hour
International calls	US capped at 10p/hour Europe capped at 20p/hour[21]		US/Europe 2.94p/minute
Other main benefits	BT assurance fault reporting One Bill and Bill analyst Call waiting and call diversion	BT 1471 voicemail	BT 1471 voicemail
Conditions	*2 year min contract, **1 year min. contract, min. spending commitment	1 year min. contract	1 year min. contract

[21] Some exclusions apply

4.15 The boundary between business and residential tariffs is however becoming less clear cut with higher end residential tariffs, such as BT Anytime, becoming increasingly similar in structure to lower-end business tariffs. This reflects the increasing trend of CPs to offer a greater range of residential tariffs to appeal to different customer types (low versus high volume, peak versus off-peak users). Similarly, BT and others, further expand the choice of tariffs by offering residential customers the opportunity to purchase some of the value-added services usually included in business packages, such as call-waiting, for an additional monthly fee.

4.16 Despite this there remain significant differences between business and residential tariffs, particularly for high volume users. For example, if BT were to increase the price of its business packages by 10%, the lowest price business call package, BT Business Plan, would be £1.73 more than BT Anytime with International saver, the nearest equivalent residential tariff. Any business making even an occasional long duration call to a UK mobile or to an international landline would remain better off using the business tariff. Similarly, a single 30 minute call to a UK mobile each month would cost £2.20 on BT Anytime compared to 25p on BT Business Plan.

4.17 There are also potentially important quality differences between residential and business tariffs, notably, the higher level of customer services offered, and entry into the business section of the yellow pages directory.

4.18 These call volume and quality differences, together with the fact that business tariffs are marketed exclusively to business customers, suggests that there is only limited demand-side substitution between business and residential tariffs[22].

4.19 Supply-side substitution between the residential and business sectors is also likely to be limited. While it is easy for a residential supplier to design a package that is attractive to business customers, it is considerably more difficult and costly to market such a package to business customers. The retailers who are currently active in the retail sector such as Sky, Tesco and Post Office, have used their established residential customer base to sell on communication products. However, such firms have limited experience in marketing to business customers who are much more diverse and difficult to reach. It therefore seems unlikely that such retailers would choose to enter the business market should tariffs in the business market increase by 5-10%.

4.20 More generally, the market evidence suggests that the residential and business markets are separate since the competitive dynamics in the two markets differ. In particular:

- The structure of competition is different in the two markets. In the residential market BT faces competition from a number of large retailers such as Sky, CPW and the Post Office, while in the business market, BT faces competition from a large number of smaller retailers;

- The competitors that BT faces are different in the residential and business sectors. In the residential market, BT's competitors are predominantly specialist retailers, in the business market, they are largely CPs;

[22] It is possible that there might exist a "chain of substitution" linking business and residential tariffs so that while they are not demand-side substitutes they may be bound by a common pricing constraint and therefore be part of the same economic market. However, it is not made clear to businesses that they could choose a residential tariff , which suggests relatively few businesses would consider switching from a businesses to a residential tariff. On balance we therefore believe that the "chain of substitution" is unlikely to be strong enough to warrant the conclusion that business and residential tariffs are in the same economic market.

- The nature of competition is different in the two markets. In the residential sector, the predominant strategy is to bundle access and calls to other products such as pay-TV and broadband. In the business market, bundling is much less prevalent, and prices are often bespoke.

- The attributes of access and calls that are valued by businesses differ in important ways to the demands of residential customers. For example, our consumer research shows that businesses tend to be more interested in access for security and reliability, whereas for residential customers, access is increasingly valued for delivering high quality broadband;

4.21 For these reasons we believe that business and residential are likely to be in separate economic markets.

There is a single UK market with the exception of Hull

4.22 At the geographic level there is a single UK market excluding Hull and a separate Hull market.

4.23 On the demand-side customers are only able to choose between the CPs that operate in their geographic area. Their ability to switch between different operators may therefore be limited particularly where a consumer lives in an area that is not served by cable or LLU.

4.24 However, all operators have national uniform pricing policies and national marketing campaigns so competition on the supply-side of the market has a clear national dimension[23]. The exception is Hull, where the main UK based retailers, including BT, currently do not offer a competing residential retail service due to the absence of access infrastructure (there is no cable, LLU, or WLR). Cable and Wireless do however provide a competing indirect access service in the business market using leased lines.

4.25 For the residents of Hull there is no effective demand-side substitution, while supply-side substitution from the rest of the UK is limited by the absence of access infrastructure, particularly WLR.

Fixed line and mobile access are in separate market for residential users

4.26 Our research shows that 79% of the UK adult population now choose to have both fixed and mobile access. This compares to only 70% who had both forms of access in 2003. While 91% of consumers now have a mobile phone, the number choosing mobile access only is growing at a rate of only 1% per annum and currently stands at 12%[24].

Table 4.2 Fixed and Mobile Take-up

Type of Access	% of UK adults 2003	% of UK adults 2008
Landline and mobile	70%	79%
Landline only	20%	8%

[23] One caveat is that Carphone Warehouse has certain tariffs which offer lower prices to customers who are able to be served by LLU.
[24] The Consumer Experience, Ofcom, 2008.

Mobile only	8%	12%
Neither	2%	1%

Source: Ofcom Technology Tracker Survey, November 2008

4.27 Mobile only access is most prevalent in low income households. For example, 24% of UK adults with an income of less than £11.5k are mobile only, compared to only 5% for those with an income in excess of £30k[25].

4.28 Our survey[26] asked mobile-only customers for the main reasons why they chose not to have a landline. The main reason given was that a landline is "too expensive" (47%). This is consistent with the finding that low income groups are more likely to choose mobile only access. This suggests that there is likely to be some substitution between fixed and mobile access, particularly for low income groups.

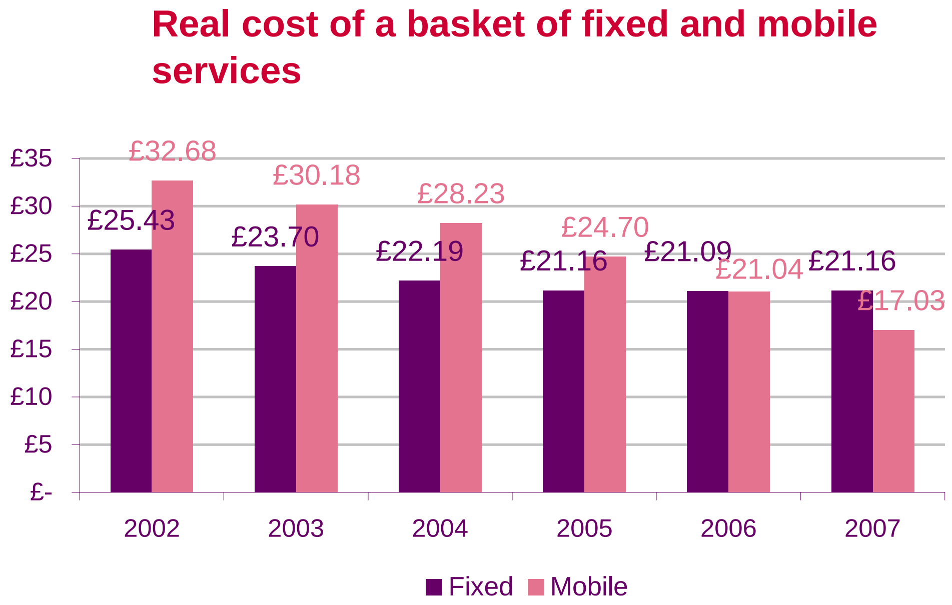
4.29 However, although the most frequently cited reason for not choosing a landline was price, the next three most frequently cited reasons were all non-price related, e.g. "living in rented accommodation" (43%), "move around a lot" (26%) and "not in property when moved in" (22%).

4.30 Our Consumer Market Research also found that demand for landlines was primarily driven by non-price factors. When respondents were asked about their attitudes to having a landline, 62% agreed with the statement ("never give up landline – feel secure with one")[27], with 44% agreeing with the statement that there is "too much upheaval to get rid of home phone", 43% stating that "mobile is not reliable enough to drop the landline" and 26% saying that they "only have a landline for internet".

4.31 Further evidence that consumers have a preference to purchase both fixed and mobile access can be seen from the fact that the proportion of mobile only users has experienced a relatively slow rate of growth over the last five years despite a very large fall in the price of mobile services. Between 2002 and 2007 the real price of mobile services declined by an estimated 45%[28] while the price of equivalent fixed line services fell by only 18%. In the same period, mobile only households grew from 7% to 10%, while the proportion of consumers having fixed and mobile access increased from 73% to 82%. This is consistent with consumers taking advantage of the falling absolute and relative price of mobile phones by increasingly purchasing both mobile as well as fixed access rather than substituting away from fixed lines.

[25] Ibid.
[26] Consumer Market Research conducted by Illuminas for this market review, 2009.
[27] Ranked the statement at 4 or 5 (where 1 means "does not apply" and 5 means "applies a lot").
[28] Ofcom Communications Report, 2008

Figure 4.3



Source: Ofcom Communications Report, 2008

4.32 However, while most consumers appear to have a strong preference to purchase both fixed and mobile access, there appears to be an important minority who regard them primarily as substitutes. For example, the proportion of respondents rating 4 or 5 (out of 5) the statement that they would "drop their landline if the mobile phone was cheaper" is 33%. This suggests that a proportion of consumers do regard their mobile phone and their landline as substitutes and would be prepared to drop the landline if the relative price difference decreased.

4.33 Our Consumer Market Research also sought to determine consumers' willingness to switch between fixed and mobile access by asking them directly how they would respond to an increase in BT's access price. In a hypothetical scenario where BT's line rental price increased by 10% (and the price of other fixed and mobile access remained constant) only 4% of respondents stated that they would cancel the fixed line with 22% responding they would switch to a different supplier. Of those who indicated that they would switch calls, only 5% (1% of total sample) would switch to a mobile phone supplier. While these hypothetical questions are more relevant for the assessment of BT's market power nonetheless they do provide some evidence that mobile access is not regarded by consumers as a particularly strong substitute for fixed line access.

4.34 Our evidence suggests that while there is some substitutability between fixed and mobile access, consumers predominantly view the two types of access as meeting different needs and have a strong preference to purchase both fixed and mobile access. We, therefore, believe that fixed and mobile access are more appropriately considered to be in a separate markets.

Fixed line access and calls in separate markets

4.35 Our market research found that the vast majority of customers (86%) purchase their access and calls from the same provider. Over 80% of BT customers purchased both access and calls from BT, while all non-BT access customers in our study purchased calls from their access provider.

4.36 However, while consumers generally buy access and calls from the same provider, our consumer research found that a sizeable minority of consumers consider access and calls to be separate purchase decisions. Our consumer research found that 38% of customers who buy access or calls from BT consider access and calls to be separate purchase decisions, while 24% of consumers who buy access and calls from rival suppliers regard access and calls as independent purchase decisions despite taking access and calls from the same supplier.

4.37 Further evidence on the extent to which consumers regard access and calls as separate purchase decisions can be seen in the way that consumers respond to hypothetical increases in the price of access and calls posed in our market research study. For example, when asked how they would respond to a 10% increase in the price of BT access, 74% of respondents indicated that they would switch both access and calls. Again this is consistent with the majority of consumers regarding access and calls together, but a significant majority considering them to be separate purchase decisions.

4.38 The SSNIP test does not provide sufficient guidance as to what proportion of customers would be needed to view access and calls as the same product in order for them to be regarded as being part of the same market. For that reason the choice as to whether to view access and calls in the same or in different markets is largely a pragmatic one. In the light of the fact that a material number of consumers still purchase fixed line access and calls separately and that an even higher proportion regards the two services as separate purchase decisions we believe that it is more appropriate to regard fixed line access and calls as separate markets.

4.39 In any event our choice to define separate access and calls markets does not affect our SMP assessment where we fully recognise the important interplay between the price of access and calls.

Different call types in the same market

4.40 We believe that there is now a single residential narrowband calls market (including geographic, fixed to mobile calls, international and other calls). The main reason for this is that consumers, with very limited exceptions, choose a single fixed line provider to meet all of their call type needs (geographic, calls to mobiles, international and others). They will therefore select their calls provider on the basis of which one provides the best value for money tariff given their particular pattern of calls.

4.41 To illustrate this, suppose a provider were to increase the price of calls to mobile numbers by 5-10%. A consumer who wished to switch to another provider of calls to mobile can only do so either by switching all of their call needs, or by purchasing additional fixed line access. The latter would tend to incur a substantial additional connection and rental cost and is unlikely to provide a realistic alternative for the consumer. Competition therefore takes place primarily on the basis of the overall value for money of the call package.

4.42 While retailers compete by offering a tariff package, we do however recognise that the competitive dynamics vary to some extent across different call types. For example, high volumes users of international calls will often chose to use a calling card or VoB, while the price of calls to mobile will be limited to a significant extent by the ability of consumers to use a mobile phone for the same call. In both of these examples there is some additional competition for consumers who have multiple forms of access. For this reason, we carry out a separate competitive assessment of calls to mobile and international calls in Annex 5.

There is not a separate market for bundles of communication products

4.43 CPs are increasingly bundling access and calls with other communication products such as broadband, mobile, and pay-TV. These bundles are often sold at a discount to the price of the individual components.

4.44 It could be argued that with competition increasingly focusing on the value for money offered by bundles the relevant market should be defined as bundles containing fixed access and voice products. A case can be made for such a market definition on both the demand and the supply-side. On the demand-side for example, consumers are increasingly exhibiting a preference to one-stop shop and to consume a bundle of communication products. On the supply-side, WLR/CPS and LLU make it relatively easy for retailers to add fixed access and voice products to bundles of other communication products.

4.45 Whether a “bundles” or more narrow access and calls market definition is more appropriate depends largely on consumer and firms’ behaviour. A bundles market will be more appropriate where:

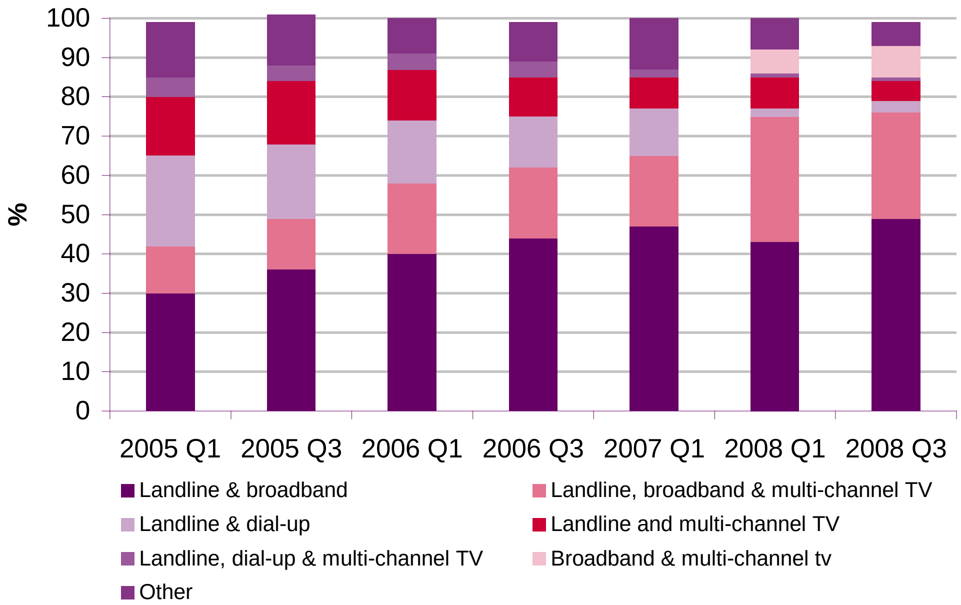
- Consumers predominantly purchase access and calls as part of a wider communications products bundle;
- Consumers are primarily focused on the overall price of the bundle that the price of individual components;
- Firms either do not sell individual components, or offer bundles at significant discounts to the price of individual components.

4.46 Our Consumer Market Research found evidence that while consumers do increasingly regard access and calls as the same product, consumers in general look at the price of access and calls separately, while 14% of residential consumers and 17% of business consumers purchasing access and calls from different suppliers.

4.47 Similarly, while CPs do offer access and calls as part of wider communication bundles, predominantly, access and calls are offered at very similar prices to BT (which is unable to offer bundles at a discount to component parts). One reason for this is that access and calls are marketed by firms such as Sky as “add-ons” to already existing bundles, rather than being part of the core bundle.

4.48 While bundles including narrowband are used in around 41% purchases, as chart 4.4 illustrates there is a wide variety of bundle types which do not readily lend themselves to be considered as a single market.

Figure 4.4 Composition of bundles



4.49 For this reason we believe that it is more appropriate to consider access and calls as separate markets rather than part of a wider "bundles" market.

4.50 However, in most respects our analysis is unaffected by the choice of market definition. For example, irrespective of whether we employed a components or bundles market definition, both definitions would include both bundled and individual component products. Market shares would therefore be largely unaffected. The only difference of substance is to the weight we put on the price of individual components. The bundled definition recognises that the prices of access, calls, and other communication products are intrinsically linked. While we prefer to define individual access and calls markets we do however recognise the linkages with the prices of other communication products as part of our SMP analysis.

Voice over Broadband calls in the same market as fixed line calls

4.51 Managed voice over broadband (VoB) also belongs to the calls markets (residential and business respectively). The reason is that the product characteristics are the same as for the fixed narrowband products – high quality and reliability. This means that at least BT's main VoB product – BT Broadband Talk and similar products launched by other providers, such as Vonage, would also be included in the relevant market.

4.52 We have considered whether this inclusion should be extended to Voice over Internet products such as Skype. We consider that the differences in quality from PSTN and VoB services marks these products as in a distinct markets, though like mobile calls (see below), it is a market that could influence the pricing of the fixed market. The evidence of limited use of such services, even when consumers have set up accounts with VoIP suppliers, would seem to confirm this assessment.

Mobile calls in a separate market from fixed line calls

4.53 With 79% of UK consumers having both mobile and fixed line access most customers clearly have a degree of choice as to whether to make a call on their fixed line or mobile. Although there will be circumstances where customers can either only use a mobile or landline or where they have a strong preference for using one over the other, in general mobile and fixed calls are substitutable for each other.

4.54 To define the relevant market we need to consider whether the competitive constraint imposed by the ability of consumers to switch from fixed to mobile calls is sufficiently strong to prevent a hypothetical monopoly supplier of fixed calls raising prices by 5-105 above the competitive level.

4.55 To address this issue our Consumer Market Research asked respondents which services did they prefer to use for different forms of contact (fixed, mobile, email) and how frequently contact was made. The results are shown in table 4.5 below:

Table 4.5 Service preferences

Type of contact	Frequency (mode)	Landline	Mobile	E-mail
Friends and Family (UK)	>1 per week	45%	30%	24%
Friends and Family abroad	< 1 per month	17%	8%	57%
Personal Affairs	Weekly	43%	21%	35%
Work related contact from home	> 1 per week	27%	22%	26%

4.56 More details of customers preferences for using landline, mobile or fixed is contained in the market research reports published in conjunction with the consultation. The key results to emerge from the survey are:

- For most types of call, other than international, consumers in general prefer to use their landline as they find it cheaper.
- However there are important differences between pay-as-you go and contract mobile phone owners:
  - o Contract mobile phone customers often have a strong preference for using their mobile phone over landline. For example, 51% of contract mobile phone users prefer to contact UK friends and family by mobile phone compared to 45% for landline;
  - o Contract mobile customers call much more frequently that other users;
  - o Pay as you go mobile customers have much stronger preference for using landline and email and often rarely use their mobile phone;
  - o For example, only 20% of pay as your go consumers prefer to use their mobile phone to contact friends and family;

4.57 These results suggest that there is a great deal of variation in the way that consumers use their phones, with contract mobile users twice as likely to prefer to use their mobile phone as pay as you go customers.

4.58 While customer preferences for using different phone services can be informative about the extent to which fixed, mobile and email are complementary or substitutable in use, it does not provide any real information on the extent to which consumers are likely to substitute between fixed and mobile in response to changes in the relative prices of making a call. To assess this, we consider first customers' awareness about the differences in the price of making fixed and mobile calls, and then examine evidence on hypothetical and actual switching between fixed and mobile in response to changes in relative prices.

4.59 The evidence from our market research survey suggests that customers in general have a clear idea of the relative cost of making certain types of calls from a fixed line or a mobile phone number. In particular, 68% of respondents regard fixed line local calls as cheaper than mobile calls to local numbers, 82% consider fixed to be cheaper for international calls, and 80% for non-geographic numbers. Off-network calls are also regarded as more expensive from a mobile phone (58% of respondents). The only calls that are regarded as being cheaper from a mobile phone are on-net calls (59% regarding these calls as more expensive from a landline).

4.60 However, there is considerable variation in the responses of pay as you go and pay monthly mobile users. This no doubt reflects the often very different tariff structures (pay as you go customers have more free minutes). For example, 72% of contract customers believe that on-net mobile to mobile calls are cheaper than fixed line calls to mobiles and 58% regard off-net calls to mobiles as being cheaper or priced at the same level as fixed line calls to mobiles. In contrast the evidence shows that pay-as-you-go mobile users regard mobile calls as being more expensive than fixed line calls for every type of call with the exception of on-net calls to mobiles. This suggests that contract customers are more likely to consider a mobile call as an effective substitute for a landline call than pay as you go customers.

4.61 Consumers were then asked how they would respond to a 10% increase in the cost of fixed line *access*. Our Consumer Market Research found that 10% of consumers would used their home phone less. Of those respondents most said they would make fewer calls (72%) while some also said they would make shorter calls (43%) (multiple answers were possible). Of those who said they would make fewer calls, 49% said they would make more calls using their mobile phones while 43% said they would use e-mail more (and 26% said they would just not make these calls at all).

4.62 The proportion of respondents using their home phone less when the *cost of calls* increased by 10% is considerably higher at 26%. When asked how they would reduce their usage, the respondents stated that they would make both fewer calls (75%) and shorter calls (36%). Of the respondents making fewer calls, 46% planned to use their mobile phones more and 41% planned to use the e-mail more.

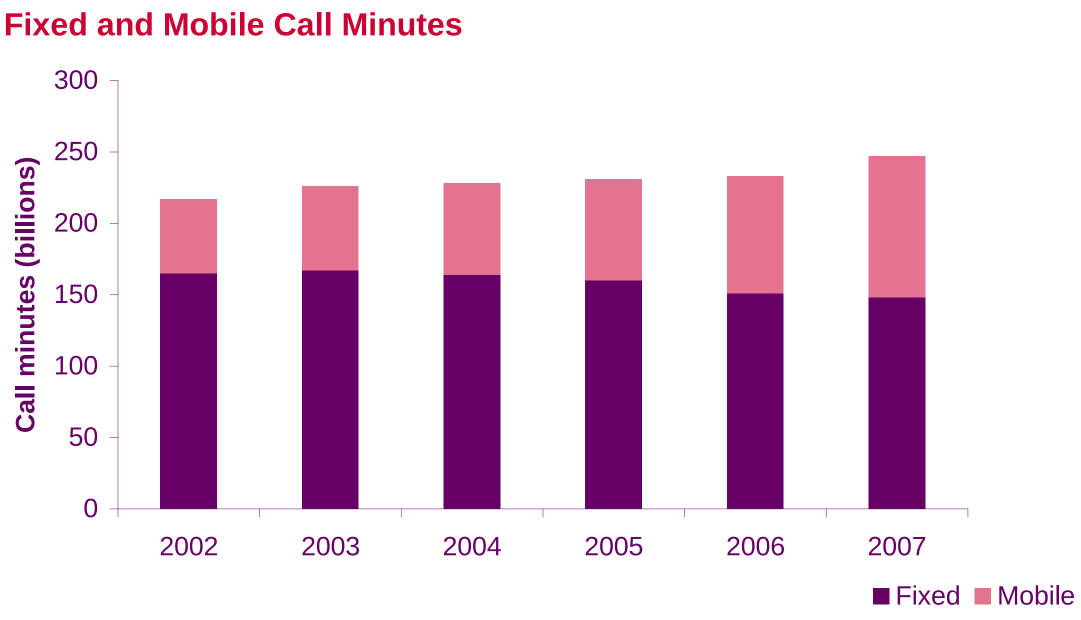
4.63 A similar pattern emerges when respondents were asked to react to a hypothetical scenario where the total price of a consumers bill (access and calls) increased by 10% with 20% responding that that they would use their land line phone less. Of those who stated that they would use their phone less, 45% noted that they would make more mobile calls.

4.64 Overall, the results of our survey suggest that mobile and landline calls are increasingly seen by consumers as substitutes and there is evidence that customers will respond to an increase in the relative price of landline calls by making more mobile calls. However, whether the extent of substitution is sufficiently strong to prevent a hypothetical monopoly supplier of fixed calls from raising prices by 5-10% above the competitive level is much less clear.

4.65 Turning to actual consumer behaviour, we see that consumers are both making more calls, and choosing to make a higher proportion of those calls on mobile phones. Overall call volumes (fixed and mobile) increased by 14% between 2002 and 2007, while mobiles share of call volumes increased from 24% to 40% (see figure 4.3).

4.66 Mobile call minutes increased by 47 billion minutes between 2002 and 2007, while fixed volumes declined by only 17 billion minutes. This suggests that while there is likely to be have been some substitution from fixed to mobile calls, most of the growth in mobile call volumes has been new calls.

Figure 4.6



Source: The Communications Market, Ofcom 2008

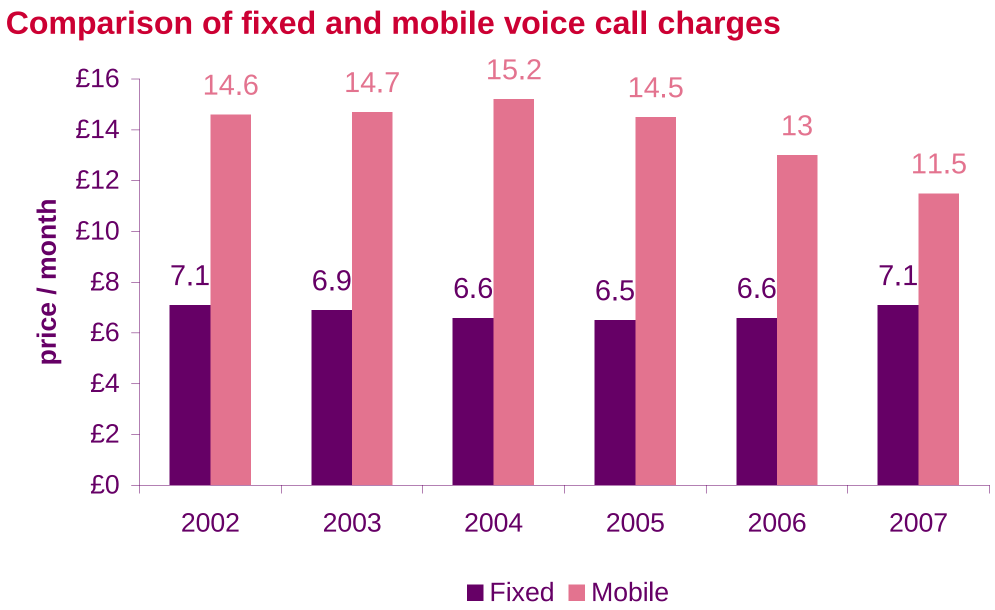
4.67 It is difficult to make direct comparisons of fixed and mobile call prices due to the widespread variation in available call tariffs and the complexity of the link between access and call prices. The simplest way to account for variations in tariff structures is to calculate the average revenue per minute paid by consumers, taking account of both access and call charges. Care needs to be taken in interpreting this measure of price as it does not take into account any differences in the calling patterns of fixed and mobile phones or the handset subsidy implicit in many mobile tariffs. It does however provide some indication as to how the price paid by consumers has changed over time.

4.68 Figure 4.7 below shows that the price of a fixed call has remained relatively constant between 2002 and 2007 at between 6.5 and 7.1 pence per minute. However, during the same period, the price of an average mobile minute fell sharply from 14.6 to 11.5 pence per minute. While the gap between fixed and mobile prices has narrowed significantly, the average revenue per minute of a mobile call is still 62% higher than the cost of a fixed call.

4.69 The decline in the gap between fixed and mobile prices is consistent with increased substitutability between fixed and mobile calls. Indeed it is possible that average revenue per minute underestimates the extent of the increased substitutability between fixed and mobile calls as a consumer's willingness to substitute a mobile for a fixed call is often determined by differences in the *marginal* rather than *average* price of a call.

The increased popularity of call bundles means that the marginal price of making a fixed or mobile call will often be zero. For example, Ofcom research[29] found that 40% of contract mobile customers usually do not exceed their allocated free voice minutes, and that of all consumers who use their mobile at home, 29% do so to use up their free mobile minutes.

Figure 4.7



4.70 It is however possible to overstate the importance of "free minutes". For example, 64% of mobile consumers are on a pay as you go tariff. While these customers are increasingly offered some free minutes, most are unlikely to have unused minutes at the end of the month. For contract customers, 14% stated that they regularly exceeded their free minute allocation or that some months they did and others they did not[30].

4.71 The decline in the gap between both marginal and average mobile and fixed prices of itself suggests that there is increasing fixed-mobile substitution.

4.72 However, it is unclear that this substitution is sufficiently strong for fixed and mobile calls to be considered to be in the same economic market. If mobile and fixed calls were in the same market we would expect that when the price of mobile calls falls this would either lead to fixed call providers reacting by cutting their call prices or, if they chose to hold prices, that their volumes would fall. However, while we have seen a 22% decline in the average revenue per minute charged by mobile phone operators between 2002 and 2007, fixed prices have remained relatively unchanged over the same period. Fixed call volumes have also held up relatively well despite the lower absolute and relative costs of mobile calls, falling by only 10%.

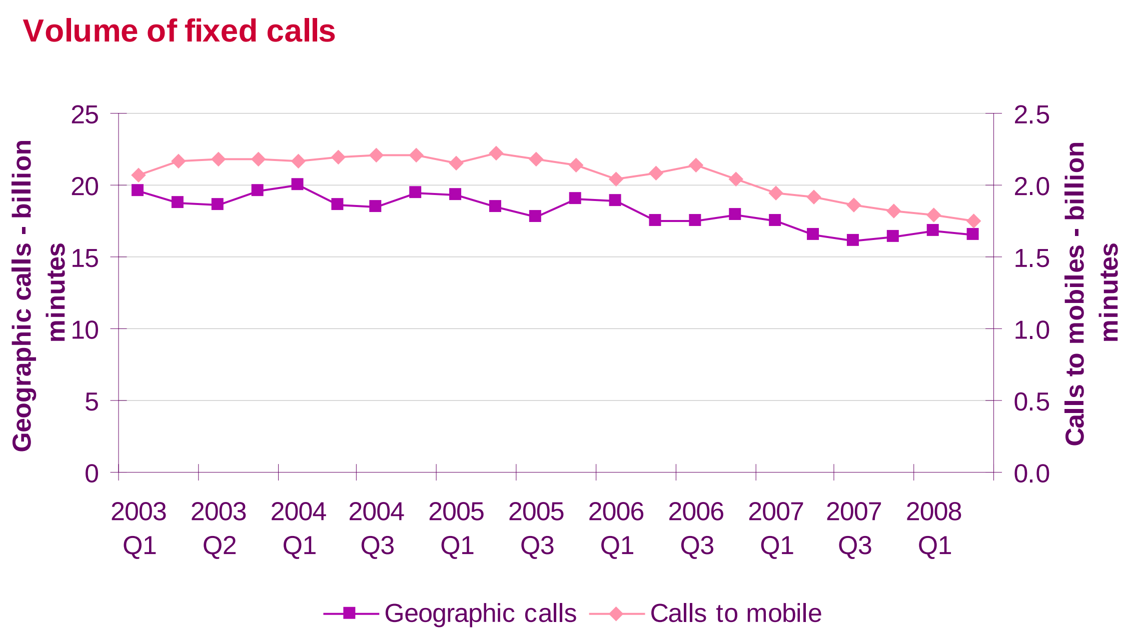
4.73 The above evidence is far from being conclusive. For example, while fixed call volumes have experienced a relatively modest decline, the proportion of call minutes accounted for by fixed calls has fallen much more sharply, from 76% in 2002 to 60% in 2007[31].

[29] Ofcom Communications Report, 2008
[30] Ofcom Telecommunications Report, 2008
[31] Ibid.

4.74 A further way of assessing whether fixed and mobile calls are in the same economic market is to look to see if there is any evidence that consumers have switched from fixed to mobile calls where there has been a change in relative prices. To do this we have compared the call volumes for geographic calls (where consumers perceive mobile prices to be relatively expensive) with call volumes for fixed calls to mobile (where consumers perceive mobile prices to be relatively cheap)[32]. If fixed and mobile calls were in the same economic market we would expect to see either fixed call to mobile volumes declining at a faster rate than fixed geographic calls (as customers switched in greater numbers to mobile) or for fixed operators to react by lowering the price of calls to mobile[33].

4.75 Figure 4.8 below shows that geographic and fixed calls to mobile have declined at a broadly similar rate between 2003 and 2008, despite consumers' general perception that fixed calls are cheaper than mobile for geographic calls, but that calls to mobile numbers are often cheaper on mobile phones, particularly for on-net calls. This data therefore suggests that differences in the perceived price of individual fixed and mobile calls have not led to significant fixed-mobile substitution.

Figure 4.8



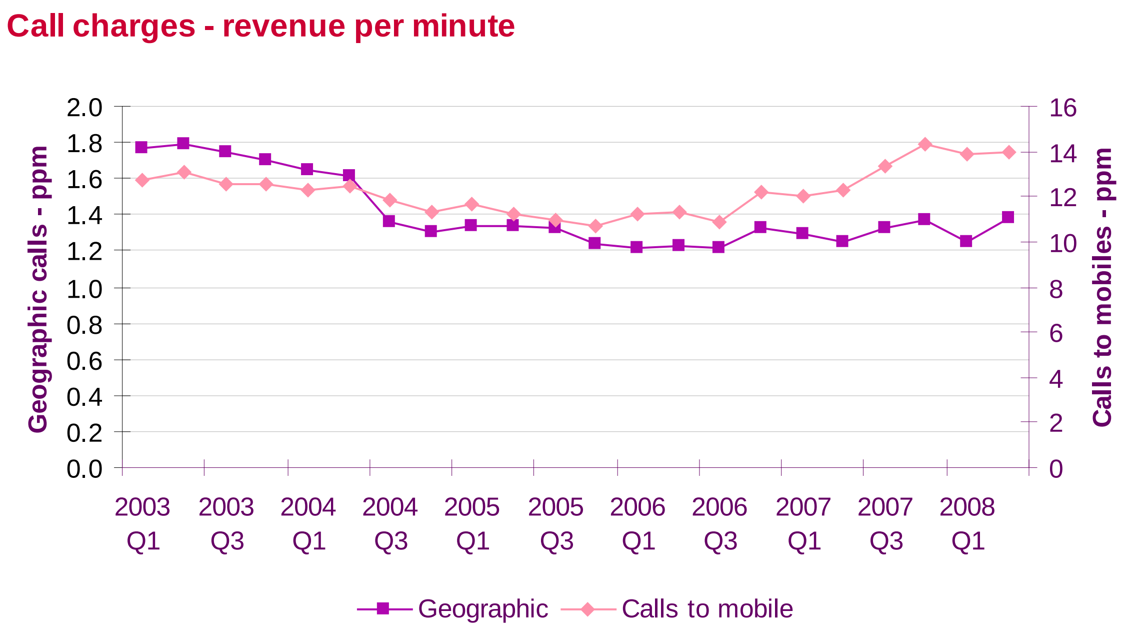
Source: Ofcom/operators

4.76 The actual prices of fixed geographic and fixed to mobile calls also appear to have followed a similar pattern between 2003 and 2008 (see chart 4.9). Again there is no evidence that fixed operators have responded to mobile competition by lowering prices where mobile calls are likely to exert the strongest pricing constraint (on fixed calls to mobile). Indeed, the price of a fixed call to mobile increased significantly relative to a fixed geographic call between 2007 and 2008. This however is largely because the

[32] Our Consumer Market Research commissioned for this market review found that 69% of consumers perceived a national geographic call to be cheaper on landline. For calls to mobile numbers, fixed calls were considered to be cheaper than mobile for only 24% of customers for on-net calls, and 58% for off-net.
[33] Although we have defined a single calls market which includes all call types, we would still expect consumers to react to differences in the relative prices of individual call types.

most popular fixed calls packages now include most off-peak geographic calls but exclude fixed calls to mobile.

Figure 4.9



4.77 In summary the evidence suggests:

- There is considerable variation in consumers' attitudes to the substitutability of fixed and mobile calls;

- High volume contract mobile consumers increasingly view fixed and mobile calls as highly substitutable, whereas many low volume contract and pay as you go consumers, continue to exhibit strong preferences for using landline;

- Consumer Market Research data suggests that a significant proportion of consumers are prepared to substitute between fixed and mobile calls in response to changes in relative prices;

- However, actual evidence of fixed mobile substitution is more limited. Although mobile call volumes continue to expand rapidly, fixed call volumes have remained relatively constant, and there is no evidence that fixed call volumes have declined more where the perceived price of making a mobile call is cheaper;

- The pricing strategies of fixed call operators also provides mixed evidence on the extent of fixed-mobile substitution. While the gap between the price of fixed and mobile calls has declined, the absolute price of fixed calls has remained relatively constant, while fixed call volumes have experienced a relatively modest decline.

4.78 Overall, while there is clear evidence of increasing fixed-mobile substitution, on balance we do not believe that such substitution is sufficiently strong to prevent a hypothetical monopoly supplier of fixed calls raising prices by 5-10%. We therefore take the view that fixed callsare likely to remain a relevant economic market. However, we recognise the growing competitive constraint from mobile calls, and this is taken into account in our SMP assessment.

Fixed line access and calls in separate markets for business users

4.79 The arguments for a separate access and calls market are broadly the same as they are in the residential market. In particular, while many businesses do make decisions based on the overall cost of access and calls, most businesses regard access and calls as separate products and are prepared to switch either access or calls products ore both in response to changes in relative prices.

4.80 Our survey, for example, found that businesses were more likely to respond to an increase in the price of calls by reducing their call volumes compared to residential consumers.

4.81 Additionally, many businesses have multiple suppliers for access, providing greater security should a fault develop on a particular line. This suggests that the decision to purchase access is based primarily on the price and quality of the access product, with the price of calls playing a much more limited role (in particular when compared to residential markets).

4.82 Bundling of access and calls is also much less prevalent in business than in residential markets. Our survey also found that a higher proportion of businesses (17%) took access and calls from different suppliers compared to residential markets (14%).

4.83 Finally, a significant minority of SMEs now purchase landline access but do not buy a fixed calls product. For example, in our Consumer Market Research, 25% of respondents agreed with the statement that they only used a landline for broadband services, while 14% agreed with the statement that they used landline for essential services such as an alarm, but used mobile for calls.

4.84 While clearly business access and call prices are linked we believe that these products are sufficiently separate for them to be considered as separate product markets.

Mobile access in separate market from fixed line access for businesses

4.85 Businesses appear to attach a similar or greater importance to retaining a landline than residential customers. For example, 82% of businesses agreed with the statement that “landline services are essential for the needs of our business and we would never consider getting rid of them.” This compares with 62% of residential consumers who indicated that they would never consider giving up a landline[34].

4.86 The reliability of mobile service/coverage is the main reason given by respondents (62%) as to why mobiles are not appropriate substitutes to landlines. Most businesses questioned considered mobile and fixed line services to be largely complementary in use with 65% agreeing with the statement, “we use a mix of landline and mobile services according to the situation”.

4.87 Business’s preference to retain their landline appears to be primarily driven by non-price factors with only 24% of respondents indicating that they would be prepared to substitute mobile for fixed access should the current price differential be eliminated.

4.88 The continuing preference by businesses to retain fixed access can also be seen in the number of business analogue exchange lines demanded. Between 2002 and 2007, business fixed lines declined from 5.5 million in 2002 to 5.3 million, a fall of only 3% .

[34] Measured as customers who gave a score of 4 or 5 (where 1 = does not apply and 5 = applies a lot) to the statement, “would never give up a landline – feel secure with one”.

4.89 As businesses appear to be very reluctant to switch from fixed to mobile access even in response to very large changes in relative prices we believe that that business fixed line access is likely to be a relevant economic market.

Different call types in the same market for business users

4.90 We believe that there is now likely to be a single narrowband business calls market which includes all call types, including geographic, fixed to mobile calls, international and other calls. As with the residential market, businesses generally choose to contract with a single fixed line calls provider[35] and so competition takes place primarily on the basis of the overall value for money offered by the call tariff rather than on the price of any individual call type.

4.91 The increased popularity of business packages which offer very low or even zero priced calls in return for a higher monthly fee provides makes it even more likely that there will be a single business calls market. For example, BT's lowest priced business tariff, BT Business Plan, caps local and national geographic calls at 10p/hour, calls to mobile at 25p/hour, and many international calls at 10p or 20p/hour. Set up charges mean that the marginal cost of calling an additional minute for these types of calls is close to zero. There is thus very limited potential for businesses to be able to save money by using different call providers for different call types, particularly where a second fixed monthly charge would be incurred by purchasing a call package from an alternative supplier.

VoB calls in the same market as fixed line calls for business users

4.92 As in the residential market, managed voice over broadband (VoB) provides the same broad product characteristics of high quality and reliability as a fixed landline. Moreover, although the calls are terminated on different networks, the price of VoB calls are the same as fixed line calls, further suggesting that they belong in the same market as landline calls. Although VOB calls often use a 05 number – which may not be attractive to businesses seeking to assure customers that they operate from a fixed location - in most cases, businesses can obtain a geographic number for free or a modest fee.

Mobile calls in a separate market from fixed line calls for business users

4.93 Business fixed call volumes declined by 58% between Q1 2003 and Q2 2008 despite there being only a 3% decline in the number of business analogue exchange lines[36]. This decline is far more rapid that in the residential sector where volumes fell by only 10% over the same period.

4.94 The reduction in business call volumes is a reflection of a number of factors including increased competition from e-mail, voice over broadband, and mobile.

4.95 Unfortunately we do not have data of sufficient quality to determine the extent to which businesses have substituted to mobile. There are however some indications from our Consumer Market Research that while there has been some fixed-mobile substitution, other factors, notably e-mail, may be more responsible for the decline in volumes.

4.96 For example, of the businesses in our sample, only 68% had mobile phones, and 13% blackberries. Of the total sample, 69% agreed with the statement "we use landline services where possible because they are cheaper than mobile." In contrast, only 14%

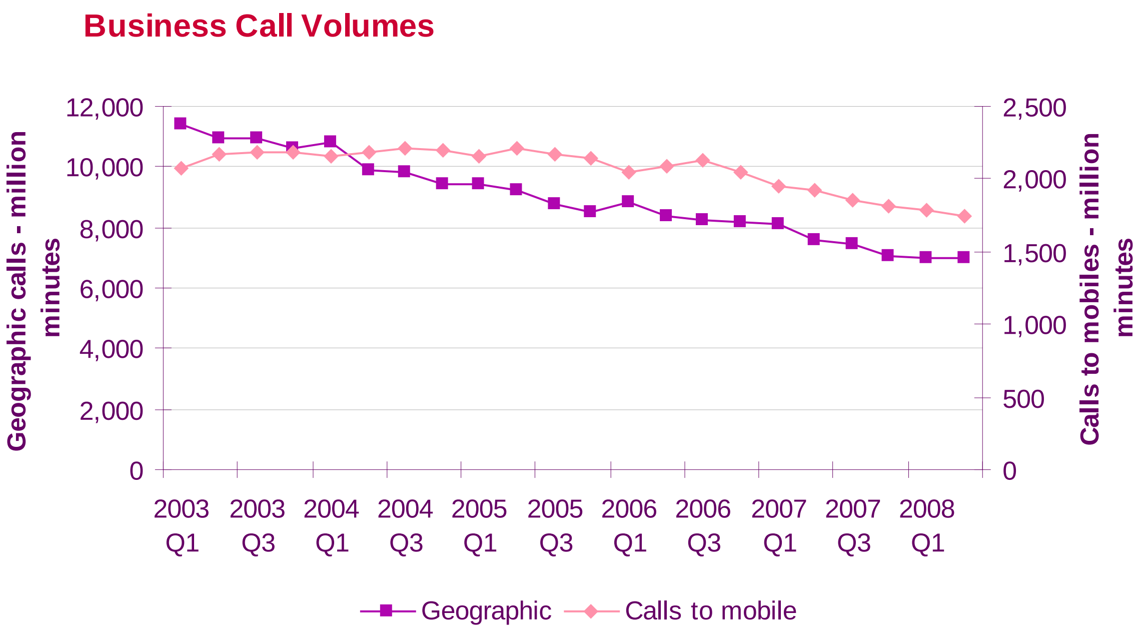
[35] In our Consumer Market Research, 88% of businesses purchased their calls from a single provider.
[36] Source: Ofcom / the parties

of respondents indicated that they generally used mobile phones. Landline calls were also widely perceived to be cheaper than mobile calls apart from calls to mobile phones. For example, 70% believed that landline calls were cheapest for calls to UK landlines, and 82% for international calls. There does not therefore appear to be widespread use of mobile phones for calls in our sample.

4.97 On-net calls to mobile phones were however perceived by 71% of respondents to be cheaper or the same cost as using landlines, although the figure fell to 36% for off-net calls.

4.98 With calls to mobile numbers often being perceived as being cheaper using a mobile phone, we might expect business calls to mobile to have declined at a faster rate than for calls to geographic numbers where use of a mobile phone is considered to be relatively expensive. However, as figure4.10 illustrates, calls to mobiles have actually declined at a significantly lower rate than calls to geographic numbers. The most likely explanation for this is that the call pattern of businesses has changed. The data does not however provide any suggestion that businesses are using mobile phones where mobile tariffs are cheaper than calling from a landline.

Figure 4.10



4.99 The price of business calls declined by 13% in nominal terms between 2003 and Q3 2008 as measured by revenue per minute. The price of residential calls has declined at an almost identical rate (12%) over the same period. This is consistent with the view that the competitive constraints faced by fixed calls providers are broadly similar in the business and residential market and that the much more rapidly decline in business volumes is largely due to longer term business trends, in particular, a greater preference for communicating by email.

4.100 For the above reasons we therefore believe that the balance of evidence supports the view that fixed business calls is a separate economic market. However, clearly competition from mobile calls is increasing and we take this into account on our SMP assessment.

ISDN2 and ISDN30 access

4.101 In considering the ISDN2 and ISDN30 markets we need to consider the supply side and demand side substitution potential between the two services and between the services and either leased lines or analogue access.

ISDN2 and ISDN30 and Leased Lines

4.102 There are a number of potential links between ISDN access services and leased lines. Specifically:

- an ISDN30 narrowband exchange line can be provided over a 2Mbit/s leased line; and
- it is possible to purchase a leased line with a bandwidth as low as 64kbit/s.

4.103 In considering whether leased lines are demand side substitutes for ISDN2 or ISDN30 exchange lines, the key issue is that leased lines provide only transmission capacity, whereas the ISDN services considered here are intended to provide switched voice and data access services.

4.104 In order to provide switched services it is necessary not just to have transmission capacity, in the form of leased lines, but to have access to a switched network that is capable of providing telephony services and an IP network capable of providing IP transit to the core Internet.

4.105 A retail customer does not have access to either a switched network or an IP network and, therefore, cannot purchase leased lines alone as a demand side substitute for analogue, ISDN2 or ISDN30 exchange lines.

4.106 On the supply side, the sunk cost of converting a leased line to ISDN2 or ISDN30 is significant. While it is possible to offer alternative services using IP based voice, at present the market is defined by customers using existing legacy ISDN equipment. This means that the market is largely fixed in size but equally is it not readily addressable by alternative systems until those legacy equipments are withdrawn from service. Therefore, we consider they are not supply side substitutes.

Demand side substitution: analogue and ISDN2 access

4.107 There are some key functional advantages of ISDN2 access compared to narrowband analogue access. These now relate primarily to (with the existence of broadband) its telephony capabilities:

- the ISDN2 service provides the capability for simultaneous Internet access and voice telephony;
- the ISDN service supports a much wider range of supplementary services (e.g. Digital Select Services and DDI); and
- many PBXs require ISDN exchange lines.

4.108 Many business customers will use ISDN2 access to provide multiple voice channels through a PBX. Larger business customers will be less interested in the data functionalities of ISDN2.

4.109 Owing to these additional capabilities, ISDN2 access customers are unlikely to find analogue exchange line services suitable demand side substitutes.

4.110 In addition, analogue access and ISDN2 business access are unlikely to be demand side substitutes given the retail price differences that exist between the two types of access.

4.111 ISDN2 business access remains approximately twice the price of analogue access. It is possible that ISDN2 prices have been set above the competitive level. However, the competitive price level of these digital access services would in any event be significantly above that of analogue access.

4.112 The functionality and retail price differences identified between both business analogue and ISDN2 exchange line services strongly suggest that a hypothetical monopolist in the provision of either analogue or ISDN2 access who attempted a SSNIP above the competitive level, would not find the profitability of this constrained by demand side substitution in significant numbers towards the other form of narrowband access. This is because existing analogue access customers are unlikely to value the increased functionality of ISDN2 access to the extent of the underlying cost difference between the two less the effect of the SSNIP. In addition, ISDN2 access customers are unlikely to be willing to give up the extra functionalities of their ISDN2 access (in terms of demand side substitution towards analogue access) given a SSNIP.

Demand side substitution: ISDN2 and ISDN30 access

4.113 ISDN30 is a relatively bespoke narrowband access service designed to cater for larger business sites when compared to single line ISDN2 services. BT states that the entry level for ISDN30 is 8 channels, and it charges on a per channel basis only above this level.

4.114 Business ISDN2 services are designed to cater for smaller business sites with single line ISDN2 services providing 2 channels. ISDN2 service is appropriate for sites requiring up to 8 voice channels. ISDN2 is not generally used for much larger sites, since the PBXs on these sites will normally be designed to support an ISDN30 connection, not a large number of ISDN2 connections. Therefore, it is not cost-effective at current prices for a customer requiring over 8 channels to substitute an ISDN30 service for an ISDN2 service.

4.115 However, the SSNIP test should be conducted from the competitive level of prices (ie cost based prices) for the two services. Whereas ISDN2 is provided over narrowband copper loops, the majority of ISDN30 access is provided over fibre or HDSL enabled copper. It is thus the case that the cost of providing a single line ISDN2 service over copper is considerably cheaper than providing the same access service over either fibre or HDSL enabled copper. Whereas the cost of providing ISDN30 over either fibre or HDSL enabled copper will be considerably cheaper than providing the same service over multiple ISDN2 copper lines.

4.116 Therefore, at competitive prices, customers of single line ISDN2 services will not find ISDN30 provision of a single line a demand side substitute nor will an ISDN30 (30 channel) customer find 15 ISDN2 lines a good demand side substitute. However, there are likely to be some ISDN customers who desire an intermediate number of channels such that they would find provision via either ISDN2 or ISDN30 demand side substitutes. The ability of hypothetical monopolists in the provision of both ISDN2 and ISDN30 to distinguish between types of customer by channels required, and therefore to price discriminate, will allow them to profitably increase their prices above the competitive level for customers whose desired number of channels is sufficiently distinct from this intermediate point.

4.117 We consider that the number of customers substituting between ISDN2 and ISDN30 is not large enough to act as a competitive constraint on suppliers of either ISDN2 or ISDN30. A hypothetical monopoly supplier of ISDN2 will be able to set prices above the competitive level to customers desiring only a few channels and a hypothetical monopoly supplier of ISDN30 will be able to set prices above the competitive level to customers desiring, for example, in excess of 20 channels.

4.118 Therefore, ISDN2 and ISDN30 constitute separate economic markets on the demand side.

Supply side substitution: analogue, ISDN2 and ISDN30 access

4.119 Attempts at a SSNIP above the competitive price level by separate hypothetical monopolists in the supply of each type of narrowband access (analogue access; ISDN2 access and ISDN30 access), would be unlikely to be rendered unprofitable by supply side substitution.

4.120 Supply side substitution between the provision of analogue access and ISDN2 access would involve considerable sunk investment. This investment would be required to enable the ISDN2 functionality, provide capacity to support the installed base of lines and undertake necessary operational support systems updates. For a network the size of BT's, this would be likely to run into hundreds of millions of pounds (KCOM would be proportionally smaller but not more cost effective).

4.121 Having invested in a network to enable the supply of ISDN2 access, suppliers would be unlikely to supply side substitute into retail analogue access provision as the potential revenues from the provision of analogue access would not allow them to recover the investments made in the digital network.

4.122 It is also the case that the provision of ISDN30 access would require considerable sunk investment to an existing analogue or ISDN2 access network. These investments would take the form of fibre rollout and/or SDSL enabling DSLAM rollout in a copper network. As the UK cable companies are not well placed to supply business customers, the provision of ISDN30 equivalent access services would require further cable rollout such that the cable networks would be better placed to supply business customers (the only source of demand for ISDN30 access services).

4.123 Given the substantial sunk investments required to provide ISDN2 and ISDN30 over an existing analogue access network and the requirement of digital access networks to earn sufficient revenues to justify their sunk investments, there is not likely to be supply side substitution and so it would not act to constrain prices set by hypothetical monopoly suppliers of each of analogue, ISDN2 and ISDN30 access to the competitive level. In addition, all suppliers who provide ISDN2 and ISDN30 exchange lines also supply analogue exchange lines. Therefore, there is no additional competitive constraint.

Conclusions

UK area excluding Hull

- We consider that there remain the following distinct nationally uniform markets for the UK excluding Hull:

- Residential Fixed Narrowband Analogue Access;
- Business Fixed Narrowband Analogue Access;
- Residential Fixed Narrowband Calls;
- Business Fixed Narrowband Calls;
- ISDN2 Access; and
- ISDN30 Access.

Hull area

4.124 We consider that there remain the following distinct uniform markets for the Hull are:

- Residential Fixed Narrowband Analogue Access;
- Business Fixed Narrowband Analogue Access;
- Residential Fixed Narrowband Calls;
- Business Fixed Narrowband Calls;
- ISDN2 Access; and
- ISDN30 Access.

Question 4.1 Do you agree with our proposed market determinations for the UK excluding Hull and for Hull? If not, please provide reasons and your alternative proposals for the market structures?

Section 5

Access Markets - market power analysis

Introduction

5.1 The purpose of this assessment is to determine the effectiveness of competition in the various narrowband access markets, both currently and in the foreseeable future. This assessment will inform our decision as to whether retail fixed access markets are competitive or whether a single company holds significant market power ("SMP"). We will assess market power for the calls markets in Section 6.

5.2 Where we find a market to be competitive, there is no continuing requirement for company specific regulation (see Section 8). However, Ofcom's involvement in the retail market will continue though sector level retail regulation, such as the General Conditions on communications companies (see Section 7).

5.3 Where SMP is found, we are obliged to consider what remedial regulations may be required to address the competitive failure.

Summary

5.4 Our conclusions in this section for the UK excluding the Hull area are:

- In the analogue access markets for business and residential no company holds SMP;
- In the ISDN2 and ISDN30 markets, BT holds SMP

5.5 Our conclusions in this section for the Hull area are that KCOM holds SMP in all markets:

- The analogue access markets for business and residential;
- The ISDN2 and ISDN30 markets

Our Approach

5.6 Article 14 of the Framework Directive defines SMP as equivalent to the competition law concept of dominance:

> "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."

5.7 Under this definition, a firm will have SMP where it has an ability to raise prices significantly above the competitive level. Firms are more likely to have SMP where they have a persistently high market share. However, even when market shares are relatively high, a firm may not have SMP where there is a high degree of rivalry between the firms in the market or where there are other significant competitive constraints on its behaviour such as the threat of entry, or the countervailing power of buyers.

5.8 To assess whether a firm has SMP we look at the following factors:

- Market shares;
- Barriers to entry and expansion;
- Customer switching costs and the intensity of competition in the market;
- Prices and profitability;
- Countervailing buyer power;
- Other competitive constraints; and
- International comparisons.

Relationship between the retail market definition and the Commission's Recommendation on relevant product and services markets.

5.9 In Chapter 2 and Annex 12 we have explained what Ofcom must do before making a market determination and that we are required to take due account of the Commission's Recommendation.

5.10 The Commission has in its Recommendation defined the following as a relevant market in accordance with Article 15(3) of the Framework Directive:

Access to the public telephone network at a fixed location for residential and non-residential customers.

5.11 Ofcom are proposing to define 8 separate access markets as set out in Section 4 (4 for UK excluding Hull area, four for Hull.

5.12 In determining the requirement for *ex ante* regulation due to market power, in the analysis set out below we will give careful consideration to the three criteria set out in the Explanatory Memorandum to the Recommendation (section 2.3), and discussed at paragraph 2.20 above:

- Barriers to entry and the development of competition
- Dynamic aspects – no tendency towards competition
- Relative efficiency of competition law

5.13 We consider that EC's criteria are addressed within our assessment. Criterion 1 is covered with the discussion of barriers to entry and expansion. Criteriom 2 is covered within the discussions of switching costs and the intensity of competition, market shares and prices and profitability. Criteria 3 is addressed only where we have identified market failure – see ISDN2 and ISDN30 markets for the UK excluding Hull and all markets for Hull – we will discuss this below.

5.14 In conducting out assessment we have drawn on information from a variety of sources including:

- Information from the consumer and SME Market Researchs conducted for this Review and published with this consultation document.

- The regulatory returns of BT[37] and KCOM[38]
- Market share information for fixed telecom providers compiled by Ofcom
- Information provided by CPs as part of a formal request.

5.15 In making our SMP assessment evidence no one piece of evidence is likely to be decisive. We therefore consider the impact of the different competitive constraints in the round.

Changes since the last review

5.16 In our last review in 2003 BT and Kingston were found to have SMP in each of the access defined. Since that review there have been a number of regulatory and technological changes that have impacted upon competition particularly in the UK excluding Hull. The most important of these are:

- A wholesale line rental (WLR) product has been developed allowing competitors to BT to provide a rival fixed access product. In Q3 2008 there were 5.1 million WLR lines in service across the business and residential markets, excluding BT's own use of WLR;
- Rival retailers can also provide fixed narrowband access through LLU. To date Carphone Warehouse is the only retailer to have deployed combined broadband and narrowband services using MPF on a significant scale in the residential market, while Sky has recently announced its intention to move to a full unbundling model[39]. A larger number of CPs have successfully deployed LLU in the business market.
- In 2007 some SMP regulations were suspended for large businesses on the basis that the wholesale inputs were of a sufficient standard to enable other CPs to offer retail services that were commercially and technically replicable to those BT might offer.

5.17 We begin our SMP assessment by considering the residential fixed narrowband access market, looking firstly at evidence on market shares, and then considering the extent of other competitive constraints in the market. We then consider the business fixed narrowband access market, followed by ISDN2 and ISDN30 access respectively. In Section 6 we will assess SMP in the residential and business call markets. Because access and calls are closely linked in a number of cases the evidence we present relates to both products combined. Where this is the case the evidence is presented once in the access section to avoid repetition. For each market we consider the UK excluding Hull and the Hull area.

5.18 We have considered whether consumers are likely to possess countervailing buyer power in each of the access and calls markets. Countervailing buyer power is more likely when a customer accounts for a large proportion of a suppliers total output, is well informed about the alternative sources of supply and is able to switch at little cost.

[37] http://www.btplc.com/Thegroup/RegulatoryandPublicaffairs/Financialstatements/index.htm
[38] http://www.kcom.com/aboutus/regulatoryinformation/docs/regulatory_statements_2007_08.pdf
[39] http://corporate.sky.com/documents/0b404e8a89164db186e8b847ced3a11c/221aa60ce8cc4089a7eb126b6c09c7e1

5.19 While residential users and SMEs obviously have no countervailing buyer power, in the UK excluding Hull larger businesses using analogue exchange lines may have a greater degree of countervailing buyer power because it should be credible for them to switch away from BT to competing WLR/CPS or, in most instances, an LLU supplier. Similarly in the ISDN2 and ISDN 30 markets businesses have the opportunity to switch to alternative WLR suppliers, and prices are often individually negotiated. However, it seems unlikely that many firms have significant countervailing buyer power because even the largest firms would account for a small proportion of BT's revenues. It is also unlikely to be economic for firms to invest significant resources in attempting to negotiate a better deal given the relative small amounts of money that could be potentially saved.

5.20 In the Hull area businesses have fewer alternatives (i.e. no WLR or LLU providers) although they may look to other alternatives (e.g. leased lines). Overall, the potential for countervailing buyer power is more limited in Hull.

Access markets

5.21 In this section we consider whether any retailer is likely to posses significant market power (SMP) in each of the four fixed access markets identified in section 4.

5.22 These markets are:

- Residential narrowband fixed analogue access
- Business narrowband fixed analogue access
- ISDN2 access (business only)
- ISDN30 access (business only)

Residential Markets for fixed analogue access

Market Shares

UK area excluding Hull

5.23 Market shares are presented in both volume and revenue (value) terms. At the time of the 2003 review, BT only faced competition from cable operators in the supply of access. BT had a market share of 83% of exchange lines, with cable on 17%.

5.24 Since then, BT has progressively lost market share to retailers providing access using WLR and LLU. At Q3 2008, BT's market share had fallen to 66% of exchange lines, with LLU/WLR retailers up to 16%, and cable's market share stable at 18%. Based on more recent information we estimate that LLU/WLR retailers share of the market has risen to 18% of exchange lines at the beginning of 2009.

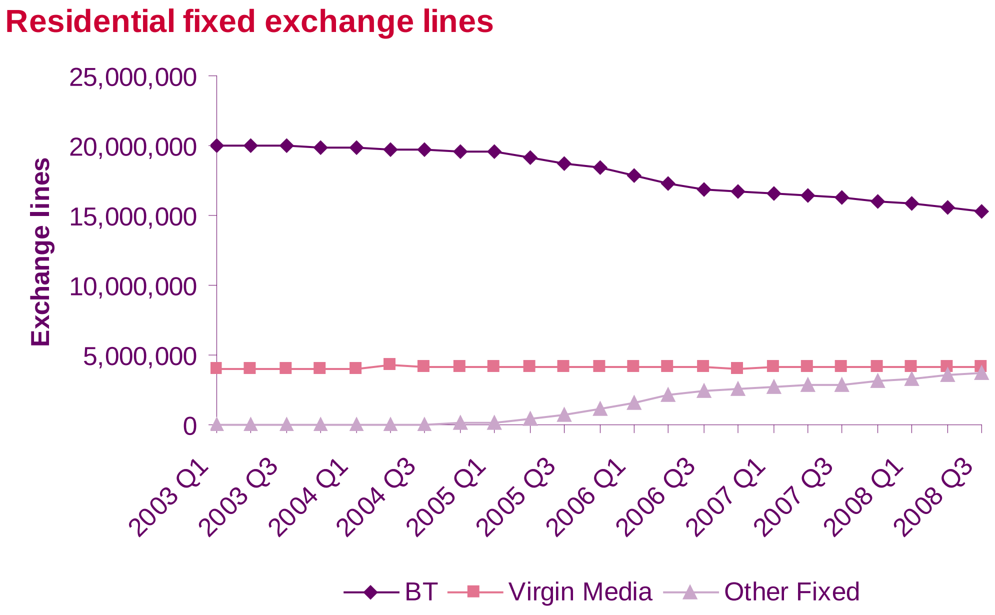
Table 5.1 Market shares of residential fixed narrowband access

	Exchange Lines			Revenues		
	BT	Virgin	Other fixed	BT	Virgin	Other fixed
2003	83%	17%	0%	80%	19%	0%
2004	82%	17%	0%	79%	21%	1%
2005	78%	17%	5%	78%	20%	2%
2006	72%	17%	11%	71%	19%	10%
2007	69%	18%	13%	67%	19%	15%
2008 Q1	68%	18%	14%	64%	18%	18%
2008 Q2	67%	18%	15%	65%	17%	18%
2008 Q3	66%	18%	16%	63%	17%	19%

Source: Ofcom/operators

5.25 BT's market share by revenue has declined at a broadly similar rate, and at Q3 2008 stood at 63%.

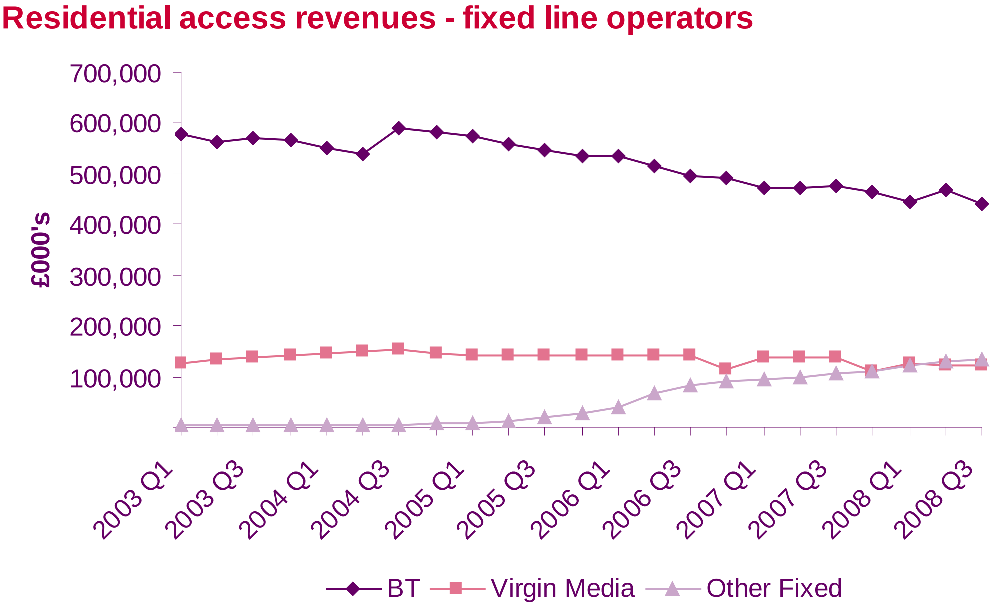
Figure 5.2



Source: Ofcom/operators

5.26 The overall size of the residential fixed access market has remained broadly stable from 2003-2007. The number of residential fixed exchange lines has declined marginally from 24.0 million to 23.3 million (see figure above), while market size by revenue has increased slightly from around £664 million per quarter in 2003 to £758 per quarter in 2008 (see figure below). The relative stability in market size is in part a reflection of the limited competition from mobile access.

Figure 5.3



Source: Ofcom/operators

5.27 We anticipate that BT's market share will continue to fall in the short term as new providers of fixed line access sell into their existing customer bases (e.g. Sky and Tesco). However in the medium term the rate of decline may slow for the following reasons:

- Around 24% of consumers do not 'actively participate' in the fixed voice market for various reasons and, thus, are unlikely to switch providers (see discussion in paragraph 5.56 below). As a legacy monopolist we might expect BT to retain a rump of 'inactive' customers. These customers might not switch because they are happy with the service they receive, believe that BT provide a higher quality service/are more reliable or are unaware of the alternatives available.

- BT offers a number of call packages aimed at low income users which are not offered by other providers. These consumers necessarily find themselves with BT if they want a fixed line phone.

- In an environment where headline package prices are similar, customers have little incentive to switch which means BT will keep a proportion of legacy customers and thus retain a relatively high market share.

5.28 However, this does not necessarily mean that BT has SMP because an attempt to raise prices might result in significant switching to alternative providers e.g. at least 34% of customers have already changed their access supplier at some point. In addition, as discussed in paragraph 5.60 below we think it would be hard for BT to target price increases at inert customers.

Hull area

5.29 There are no alternative residential access providers in the Hull area (as evidenced by KCOM's Regulatory Financial Statements reporting zero external sales for residential analogue exchange line services). The number of residential exchange lines provided by KCOM has declined slowly over recent years which may suggest some limited substitution to mobile only access, though would also be influenced by other factors – demographic factors impacting on the number of households, household wealth and the same reduction in second lines found in the rest of the UK. The table below shows the number of exchange lines provided by KCOM.

Table 5.4 Residential exchange lines provided by KCOM

	2003	2004	2005	2006	2007
Number of exchange lines provided	157,856	155,666	152,449	150,483	149,106
% change on previous year	-1%	-1%	-2%	-1%	-1%

Source: S135 information provided by KCOM

5.30 Due to the absence of alternative residential access providers we consider that KCOM has a 100% market share, hence there is a presumption that KCOM is dominant.

Barriers to entry and expansion

UK area excluding Hull

5.31 The threat of potential entry may deter a dominant incumbent from raising prices above competitive levels. However, if there are significant barriers to entry and/or growth this threat may be weak making it possible to exert SMP.

5.32 There are two ways for a communications provider to enter the retail access and calls market in the UK:

- Building infrastructure to provide services over own network;
- Using the incumbent's network to provide access/calls services using regulated products (e.g. LLU, CPS, indirect access).

5.33 The former approach would incur significant sunk costs because a large investment is required to create an efficient telecommunications network and it is likely that little of this could be recovered if the entrant decided to leave the market. This is likely to be a significant deterrent to entry.

5.34 In addition, telecommunications networks benefit from significant economies of scale which means average costs fall as output increases. Thus, we would expect an operator with a larger volume of traffic to have a cost advantage over a smaller rival. This means an entrant would need to take a significant share of the market if it is to compete with an incumbent. To gain such a large market share the entrant would have to price below the incumbent which would make it more difficult to recover sunk costs – a further deterrent to entry.

5.35 However, where an entrant can make use of the incumbent's network entry may be significantly easier e.g. because there is no need to incur sunk costs building a network. This is made possible when wholesale remedies are in place to enable competitors to replicate the services offered by the incumbent e.g. WLR/CPS and LLU.

Developments since the last Review

5.36 At the last review in 2003, barriers to entry to retailing fixed access were extremely high due to the absence of adequate wholesale products. Since then wholesale products have been successfully developed and deployed and now retailers no longer need to have their own access infrastructure but can either rent lines from BT or invest in LLU. This has enabled specialist retailers to emerge including Sky, Tesco, the Post Office and SSE. These retailers often supply a "white label"[40] access product, which they sell in conjunction with other retail services such as voice calls, broadband, pay TV and energy.

5.37 WLR/CPS provides a particularly easy route to entry as retailers do not have to expend any sunk costs in infrastructure. While there will be some sunk costs associated with marketing a new retail service, these costs are likely to be relatively modest given that most retail entrants already have a well established customer base to market to, and they are likely to enjoy substantial economies of scope.

5.38 Since 2004, a total of 12 significant new providers have entered the market to offer WLR services. At the end of January 2009 there were around 2.7 million residential WLR lines, representing approximately 12% of total exchange lines.

5.39 Unlike WLR, LLU does require some investment in equipment at local exchanges. However, although there are some sunk costs, there are also strategic benefits to investing in LLU as it allows services to be supplied at a lower cost. Carphone Warehouse has led the way in investing in LLU. Where LLU is not available, it is able to supply customers using a WLR/CPS product to enable it to gain a wide geographic reach.

5.40 The rate at which exchanges are being unbundled (that is other Communications Providers directly providing services through connection to the local access line) slowed during 2007. This perhaps reflects the fact that most of the larger and commercially important exchanges have already been unbundled. However, the rate at which unbundled services has been provided has accelerated as more people living in unbundled areas take up LLU services. By September 2008 there were around 1.4 million residential LLU lines, an increase of over 400% relative to 2006.

5.41 Competition is enhanced because other providers such as C&W and Gamma also offer WLR and CPS services to retailers on their own and others' infrastructure. In response to this BT has developed a wholesale calls product which competes directly with WLR/CPS providers further enhancing competition and choice in the market.

Entry strategies

5.42 The ability of new entrants to add "white label" access and calls products to existing bundles of communication and other products appears to have increased the attractiveness of entry. The popularity of bundled products has increased with 40% of consumers now purchasing multiple communications services from a single supplier. There are a number of reasons for this:

[40] White Label products are wholesale products which CPs can purchase and resell without direct investment in a network. It allows the CPs to offer a retail service at low risk and they can focus on other elements of either the service or their business.

- Adding access and voice products to pre-existing bundles allows new entrants to differentiate their product from BT. This offers some protection against a potentially aggressive pricing response from BT for what is otherwise a homogeneous product;

- Retailers are able to market to an established customer base.

- By offering a "one stop shop" this can increase the attractiveness of switching away from BT.

- Retailers are able to offer bundled communications products at a discount to the stand-alone component costs, whereas SMP regulations currently restrict BT's ability to bundle at a discount.

Hull area

5.43 Although there is potential to develop wholesale products there are currently no WLR or LLU providers in the Hull area. Appetite to enter the Hull market appears limited, probably because the fixed costs that would be incurred to develop a presence in Hull are high in relation to the relatively small market. This acts as a significant barrier to entry. Furthermore to attract customers away from the incumbent and overcome switching costs an entrant would have to offer substantial discounts or a differentiated (and valued) service. The anticipated revenues from such a strategy may be insufficient to cover costs of entry.

Customer switching costs and the intensity of competition in the market

UK area excluding Hull

5.44 Even if a firm has a relatively high market share, it may not have SMP if competition from rival firms is relatively intense. This may be the case, for example, if rivals supply a product which provides a very close substitute, or if customers have relatively low switching costs and are willing to move to competing suppliers should the price charged by the incumbent rise significantly above the competitive level. Conversely, SMP is more likely if rivals target different customer groups or if the customers of the firm with the high market share are relatively inert or otherwise do not exhibit a willingness to switch.

5.45 To examine the intensity of competition that BT faces from its competitors in this section we look at the following:

- Whether rivals supply products which are close substitutes to BT;

- Evidence on actual switching behaviour;

- Evidence on sensitivity to price changes;

- Consumer engagement, awareness and perceptions; and

- Barriers to switching.

<u>Rivalry between BT, other fixed, and cable operators</u>

5.46 At the time of the 2003 market review, BT in effect only faced competition in the supply of access from cable operators. More importantly, cable was, and remains, geographically limited, with cable only available to around 50% of UK households. This limited geographic scope reduces the ability of cable to compete aggressively with BT in non-cable areas unless wholesale voice products are available at attractive prices.

5.47 Switching is more likely to occur when there is a range of price points and offers in the market and consumers can choose between differentiated products. Our survey of the current market suggests that the basic package price for access and calls products is fairly uniform. The subscription for fixed line rental is generally around £10-£11 and most operators have broadly similar incremental cost for call packages (e.g. unlimited weekend and evening or anytime calls to landlines) - see table below.

Table 5.5 Line rental and call package tariffs for selected retailers

	Line rental	Line rental + unlimited weekend calls to UK landlines	Line rental + unlimited evening and weekend calls to UK landlines	Line rental + unlimited anytime calls to UK landlines
BT[41]	£10.27	£10.27[42]	£10.27[43]	£15.12[44]
Virgin Media[45]	£11.00	£11.00[46]	£14.45	£18.95
Sky Talk[47]	£10.00	-	£10.00	£15.00
CPW - Talk Talk[48]	£10.50	-	£10.50[49]	£14.99[50]
Tiscali	£10.99	£10.99	-	-

Source: Ofcom/operator websites

5.48 In a market where the prices and products are fairly homogenous we might not expect to observe significant switching activity. This is because there is little to be gained (in terms of price) from changing supplier and there will always be some transactions costs incurred (e.g. time spent researching and instigating the switching process). This is a factor to take into account when considering actual switching behaviour below.

Actual behaviour

5.49 Actual switching is one of the most important factors in determining the competitiveness of a market. BT's market share currently stands at 66% which suggests at least 34% of consumers have switched provider at some point. The number of switchers could be significantly higher because BT is likely to have regained some customers that previously switched away. Around a quarter of consumers claimed to have switched at the time of the last Review. The Consumer Experience report 2008 suggests the proportion of people switching each year has remained fairly constant over recent time at around 12%.

[41] BT has announced that it plans to increase the price of access by £1 from 1 April 2009.
[42] No minimum term, unless customers order a new phone line or switch to BT from another provider, where a 12 month contract applies to line rental.
[43] 12 month renewable contract term otherwise package costs an additional £2.65 per month.
[44] 12 month renewable contract term otherwise package costs an additional £0.97 per month.
[45] 12 month minimum contract on all Virgin packages.
[46] Only available to customers who purchase a phone line with another Virgin Media product.
[47] Only available to Sky TV customers.
[48] Talk Talk customers get free calls to each other.
[49] Increases to £13.15 after 12 months.
[50] Increases to £15.99 after 12 months.

5.50 The proportion of customers who have switched out of fixed access completely to become mobile only households remains relatively low at 12%, an increase of 4% since 2003.

Sensitivity to price changes

5.51 If a firm has SMP we would expect that its customers would be unlikely to switch supplier in response to an increase in price. To test this, our market survey asked customers from all of the leading fixed narrowband access suppliers how they would respond a price increase of 10%[51]. In response:

- 22% of customers would switch supplier
- 10% would use the phone less
- 4% would cancel their line.

5.52 This suggests that customers are relatively price sensitive and would be willing to switch.

5.53 What is also notable is that, perhaps contrary to expectations, BT customers appear to be more price sensitive and less loyal than those of their rivals. In particular, 25% of BT customers stated that they would switch supplier compared to only 18% of customers using other suppliers for fixed access. BT customers also stated that they would be more likely to use the phone less (11% compared to 8% for non-BT customers).

5.54 There are a number of possible explanations for this finding. One possibility is that BT customers appear to be more price sensitive because they perceive that BT offers poorer value for money. Another possibility is that many customers who do not use BT are purchasing access as part of a wider package which is also likely to include calls, broadband, and perhaps other products such as pay-TV (discussed further in paragraph 5.63).

5.55 Although there are a number of possible ways in which this data might be interpreted, what we do not observe is any particular evidence of stated loyalty to BT.

Consumer engagement and awareness

5.56 Consumer engagement in the fixed line market has increased over time in relation to both access and calls. The 2008 Consumer Experience report showed that 25% of consumers were ‘engaged’ in the fixed line market (up from 21% in 2007) and 26% were reported as ‘interested’ in the market. The proportion of consumers reported as ‘inactive’ (and thus unlikely to switch) has declined over time – from 28% in 2007 to 24% in 2008. The proportion of engaged consumers within the bundled services segment has increased from 30% in 2007 to 41% in 2008. Most of these bundles will contain a fixed line element so this is an important factor in determining the competitiveness of the fixed line sector.

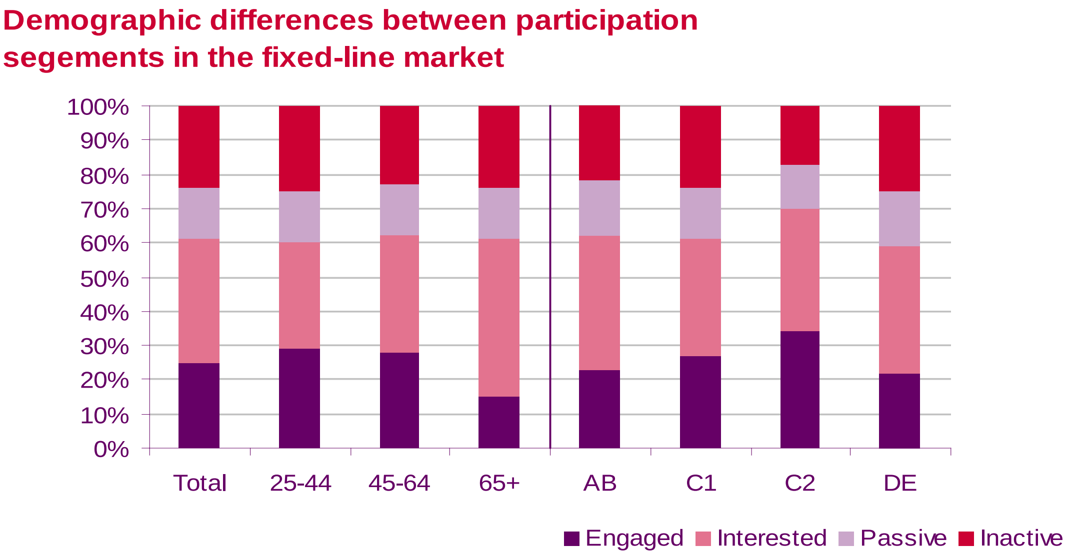
5.57 A level of awareness about alternatives is a necessary precursor to switching. Despite increasing levels of engagement in the market, the Consumer Experience reported that only around 50% of consumers were spontaneously able to identify two or more suppliers (i.e. at least one supplier in addition to their own). When prompted 80% of

[51] Respondents were asked to think about what they might do if there was a permanent change in the price of their home phone line rental when the price of calls was unchanged.

consumers were able to name two or more suppliers. This compares with 78% of consumers that were spontaneously able to identify two or more mobile suppliers. This might reflect different levels of advertising for fixed and mobile telecoms companies (e.g. mobile companies more frequently running high profile advertising campaigns as well as the significant amounts spent on a direct retail presence).

5.58 As part of the SMP assessment we have considered whether BT would be able to discriminate against its more inert (non market active/aware) customers. Our analysis suggests that this would be very difficult for BT. According to the 2008 Consumer Experience report, this inactivity is spread fairly evenly across age and socio-economic groups (see figure below).

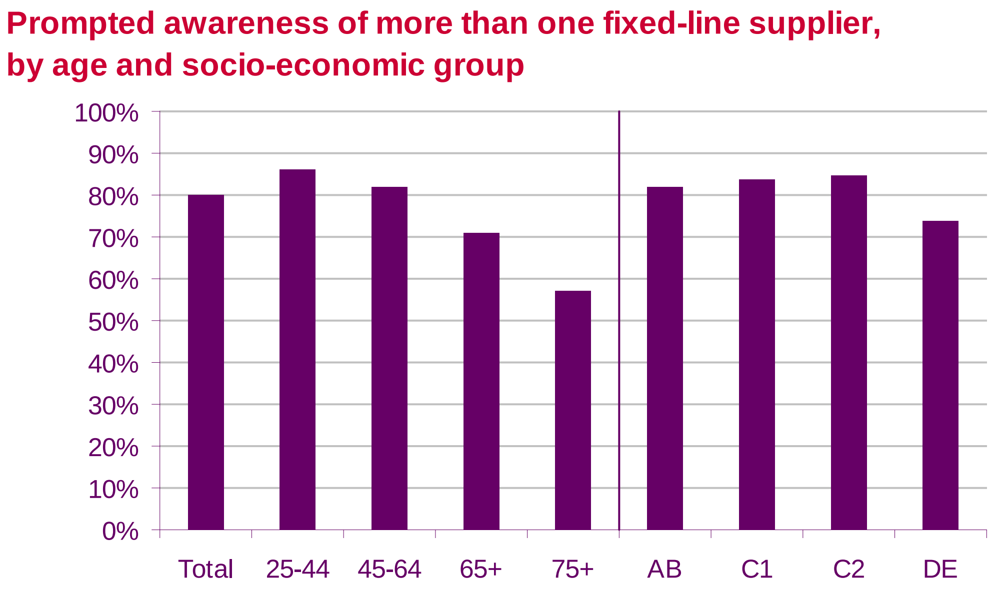
Figure 5.6



Source: Ofcom

5.59 Inactivity does not seem to be simply a factor of awareness of competition. Comparing figure 5.6 above with figure 5.7 below shows that levels of awareness are higher than levels of activity. This suggests that a significant proportion is inactive through choice.

Figure 5.7



Source: Ofcom

5.60 The absence of a clearly defined social grouping for lack of activity suggests that BT might have difficulty targeting inactive consumers. In addition, some consumers who are currently inactive but aware of competition may well respond if prices increased significantly.

5.61 We are already seeing the growth of retail providers who are specifically targeting narrowband customers on price alone and who have a wide and effective distribution/marketing presence (for example the Post Office and Tesco). The availability of attractive alternative products means BT would be less likely to find a discriminatory strategy profitable (because customers could easily switch away to other providers).

5.62 The above notwithstanding, we consider that it is important to avoid changes to regulations that would allow greater customer segmentation to the detriment of inactive customers. For example, we may need to be careful about any proposals that would allow BT to target discounts to customers indicating an intention to leave. This is something we will continue to monitor.

Barriers to switching

Impact of bundling

5.63 Around 41% of consumers buy a bundle of communication services[52], which is likely to contain a fixed voice component. It is possible that bundling makes it less likely that people will switch in response to an increase in the phone bill for the following reasons:

- An increase in the price of one component i.e. the phone bill might be small in relation to the total spend on the bundle – thus is less likely to trigger a switch.

[52] The Consumer Experience, 2008 p43

- The Consumer Experience report 2008 suggested that bundlers' perceptions of the switching process could be a barrier to switching i.e. switching multiple products with different switching processes was an additional hurdle[53].

- In addition, the research found that larger bundles were valued more highly indicating a greater reluctance to switch.

5.64 However, the consumer research conducted for this review suggested that bundling was not a significant constraint on switching behaviour e.g. only 14% of consumers who said they would 'do nothing' if call/line prices increased said this was because they have a bundle with pay TV and broadband access. 43% said they would do nothing because switching was too much hassle/upheaval.

Frictions in the switching process

5.65 An incumbent with a large market share might benefit from increasing friction in the switching process because this might aid customer retention. There are a number of ways to create friction e.g. making the switching process onerous and lengthy or tying the customer into a contract. Imposing minimum contract terms can be a legitimate practice and means firms can offer discounts/incentives up front to encourage switching which can be recouped later. However, once in a contract consumers might be discouraged from switching e.g. if they face penalties for breaking the contract or can only terminate the contract if a period of notice is given.

5.66 BT has encouraged customers to move onto a 12 month renewable contract by offering extra inclusive calls as part of the call package[54]. This is part of a trend in the market to seek greater levels of consumer commitment. Customers get extra benefits from signing up for a minimum term and may end up with a lower bill overall. However, adding a minimum term means that consumers are only able to switch at particular times and when the appropriate notice is served – which might add a friction into the switching process. Our main concern is to ensure that any contract is clear and fair and that customers are compensated appropriately for any longer term commitment. We have recently set out our guidelines for the sector on this[55]and we expect BT and all other CPs to comply.

<u>Summary</u>

5.67 On balance we think that an increase in the number of suppliers offering access and calls products has improved choice and encouraged switching in the fixed telecoms market. On the other hand, we note that there is some evidence suggesting that consumers buying a fixed line as part of a communications bundle might be less likely to switch than those buying a single product.

Hull area

5.68 As noted above, there are no alternative access suppliers in the Hull area so there is little scope for switching. The number of residential exchange lines provided by KCOM has declined slowly which is likely due to mobile substitution.

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[53] See page 98-99 of The Consumer Experience 2008.
[54] BT customers choosing a 12 month renewable contract receive unlimited evening and weekend calls as part of the basic subscription. Customers with no minimum term only get free weekend calls on the basic package and must pay an extra £2.65 to get unlimited evening calls.
[55] http://www.ofcom.org.uk/consult/condocs/addcharges/statement/

Pricing and profitability

UK area excluding Hull

5.69 The ability to price persistently and significantly above the competitive level is an important indicator of market power. In a competitive market, individual firms should not be able to persistently maintain prices above costs (including a normal return) and thus sustain excessive profits. However, in the short term high profits can be explained by factors such as innovation and unexpected changes in demand. Low profits might indicate inefficiency of a firm rather than effective competition.

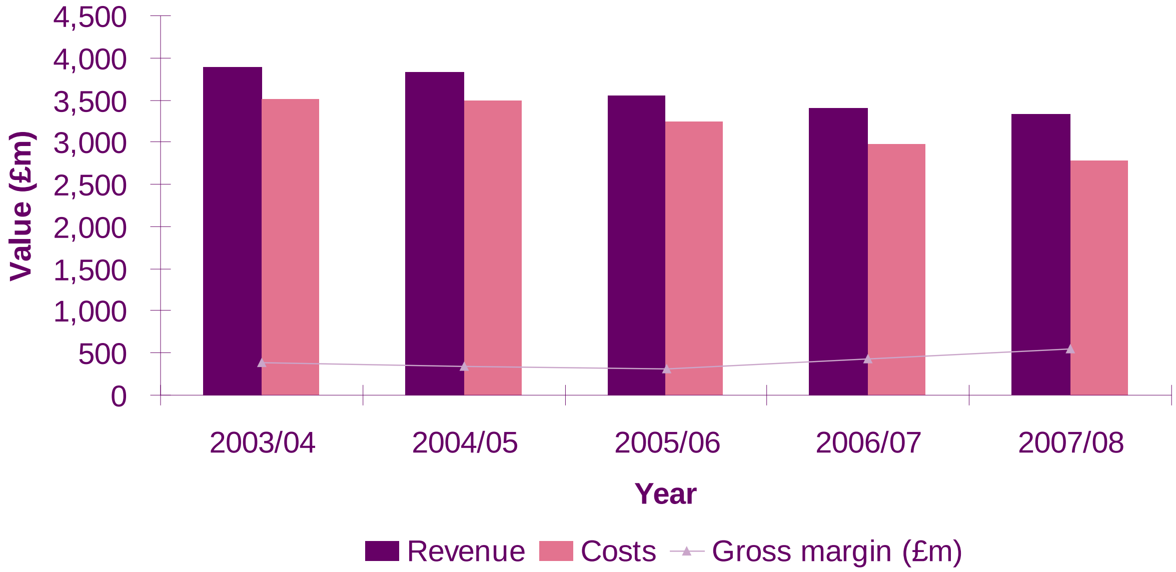
Profitability

5.70 Historically BT has earned a negative gross margin (i.e. allocated costs are greater than revenues) on the supply of residential analogue exchange line services. Since 2003, BT has been able to reduce costs at a faster rate than access revenues have declined. However, BT continues to make a loss on the supply of access taken in isolation (e.g. BT's gross margin on residential access was -£61 million in 2007/8).

5.71 A low price of access can increase demand for calls so it is also relevant to examine BT's profitability in the supply of access and calls products combined. Here, BT's gross margin declined between 2003/4 and 2005/6, with an improvement in 2006/7 and 2007/8 (see figure below). BT's revenues and costs have declined in its retail SMP markets, largely as a consequence of declining call volumes.

Figure 5.8

Total SMP residential markets - revenues, costs and returns from 2003/04 to 2007/08



Source: BT's regulatory accounts

5.72 We have considered whether it would be appropriate to analyse other profitability measures (for example return on capital employed). Because BT retail has few fixed assets (and thus little capital) we do not believe presenting these statistics is meaningful.

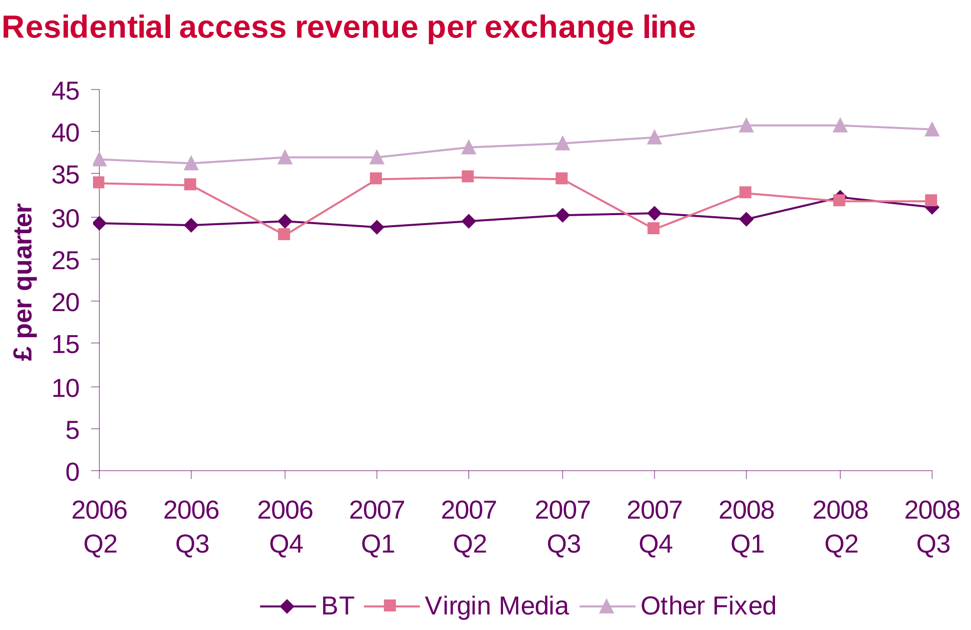
We believe a better measure is a comparison of the revenue per line or minute that BT is able to earn access or calls, both over time and versus other providers. We present this information in the pricing section below.

Pricing

5.73 Table 5.5 above sets out the current access tariffs available from a selection of leading retailers. As noted above, the price of the most basic access package is very similar across retailers, ranging from £10 (Sky) to £11 (Virgin Media). BT's basic tariff, at £10.27, is towards the lower end of this range. It is difficult to compare tariffs over time and across different retailers due to the complexity of the tariff structure (e.g. retailers offer slightly different call packages and terms). It may also be misleading to look at the price of access in isolation from the price of calls given that consumer research suggests that customers frequently purchase access and calls from the same supplier. To approximate the price of access we look at the revenue per line from line rental charges[56]. In addition, we also look at the total revenue (i.e. line rental and calls) per line.

5.74 BT's retail access prices were regulated prior to 2006 which constrained their pricing behaviour. The figure below shows that BT's current access prices are only marginally higher in Q3 2008 than they were in 2006 in nominal terms[57].

Figure 5.9



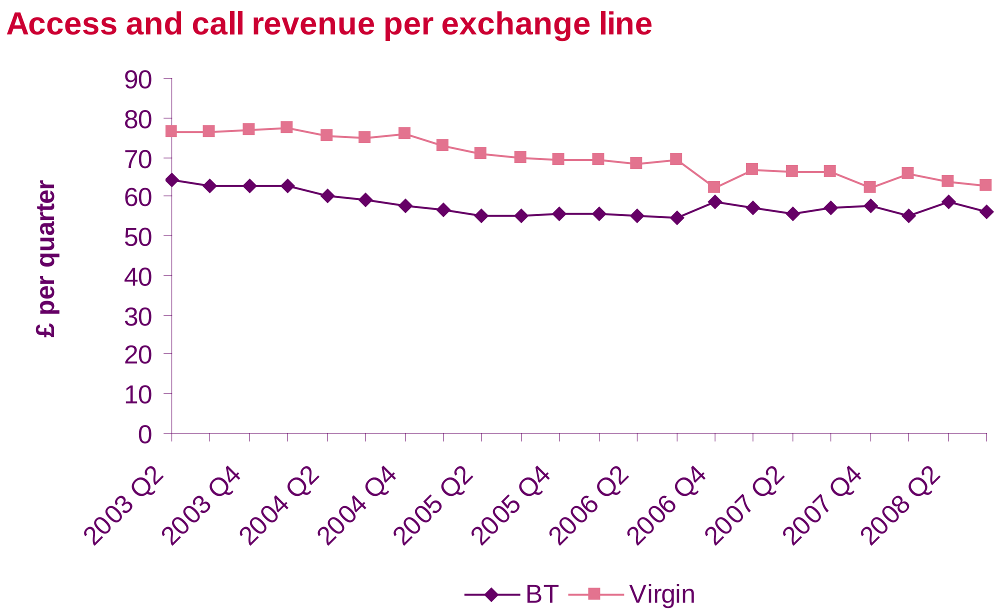
Source: Ofcom/operators

5.75 BT's revenue/line is broadly comparable with Virgin Media, but is lower than the revenue/line earned by other fixed operators. As noted above the advertised tariffs for the largest retailers are very similar so this may reflect a reporting issue.

[56] For BT, the reported access revenues are calculated using the cost of the most basic rental package available (currently the unlimited weekend call package) while any revenues from call packages in addition to this are recorded as call revenues. Other providers may have different reporting conventions.
[57] Data from 2003- Q2 2006 is not presented due to reporting issues.

5.76 The figure below shows total revenue per exchange line (i.e. access and calls) for BT and Virgin (other fixed cannot be presented due to data quality issues). The figure shows that BT's total revenues per line have declined since the last review and are consistently below Virgin. Total revenue per line has increased slightly since price regulations were relaxed in 2006.

Figure 5.10



Source: Ofcom/operators

Hull area

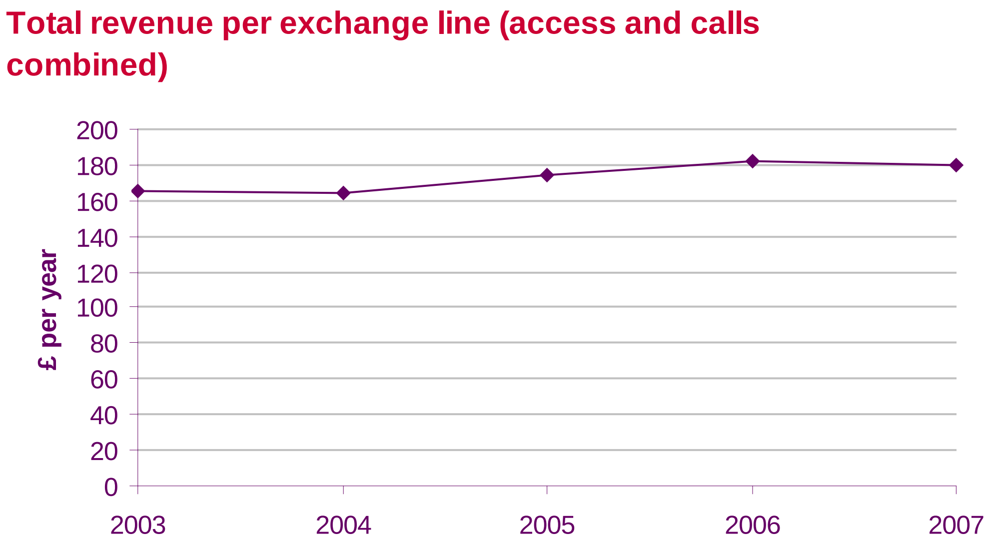
Profitability

5.77 KCOM's return (turnover minus costs) on residential exchange line services in Hull was unchanged in 2008 relative to 2007 (at around £7,600,000). The return on mean capital employed remained constant at 13% in 2008.

Pricing

5.78 The figure below shows KCOM's total annual revenue per exchange line in nominal terms (access and call revenues combined). The figure shows that revenue per line increased over 2005 and 2006, by 6% and 4% respectively. However, overall KCOM's revenue per line is lower than BT's (in 2007 BT's revenue per line was £228 compared with £182 for KCOM). This could reflect differences in reporting, the number or type of calls made, and the different call packages offered.

Figure 5.11



Source: KCOM S135 information

5.79 The structure of KCOM's tariffs is similar to BT[58]. There are two main differences between the call packages:

- KCOM includes free local geographic calls (at any time) as part of all the packages.
- KCOM includes some free weekend fixed to mobile minutes as part of some packages.

5.80 Differences in the 'inclusive' element of the package make price comparisons difficult. However, it would appear that pricing is broadly comparable. We have compared the call package which offers inclusive unlimited weekend calls as an example. BT's unlimited weekend calls package costs £10.27 per month. The KC Talk2 package offers free weekend calls for £13.70 per month, but also includes local geographic calls (at any time) and includes 30 minutes of landline to UK mobile calls at the weekend. If we assume that the £3.43 premium for KCOM's package is purely due to the extra mobile minutes offered, this implies a price of 11p per minute for the 'inclusive' mobile calls (assuming the call allowance is used up). BT's standard price for daytime mobile calls is comparable at about 12p per minute.

Other competitive constraints (including strategic pricing and dynamic issues)

UK area excluding Hull

Relationship between fixed and mobile access

5.81 As discussed above, our consumer research suggests relatively few customers would switch to mobile only in response to an increase in the price of fixed access. However,

[58] i.e. a basic fixed cost for line rental which includes some 'inclusive' calls with the option to choose additional 'inclusive' calls for an incremental fixed cost. Calls outside the inclusive package are charged on a per minute basis.

any customer who gives up their fixed line will also drop their fixed calls and (if taken) fixed broadband products. A fixed access provider would therefore lose not only the margin they earn on access, but potentially also the margin they earn on calls and broadband products (if provided). If these margins are significant, then competition from mobile access could impose some competitive constraint on the price of fixed access.

Relationship between access, calls and related services

5.82 Although we found access and calls to be in separate economic markets, we recognise that the price of access may play an important role in driving demand for calls and other related products such as broadband. For example, our consumer research found that 74% of BT customers who stated that they would switch to an alternative supplier of access in response to a 10% price increase would also switch their calls.

5.83 In addition, a customer who drops BT's access and calls product may also drop BT's broadband. Our Consumer Market Research found that 45% of BT access customers took a BT internet product so the number of customers who switch internet provider could potentially be quite significant. If even a limited number of consumers did decide to switch the whole bundle when the cost of one component increased, this would result in a more substantial loss of revenue for ancillary services and the provider would lose the ability to cross sell products. Cumulatively this potentially means that a supplier might not find it profitable to raise prices even if relatively few customers switched. This means that when competition takes place among suppliers selling bundles two things happen: (a) demand is less elastic and consumers are less likely to switch for any given price increase (i.e. consumers are stickier) and (b) when consumers do switch the cost in lost margin is greater.

5.84 The inter-relationship between access, calls and broadband prices in principle makes it more difficult for a firm with a high market share of access to exploit SMP as there is likely to be some strategic incentive to keep access prices low in order to drive demand for related calls and broadband products.

Hull area

5.85 Some of the points above may be relevant to KCOM e.g. demand for calls and broadband may be relevant when pricing access. However, the lack of alternative providers for fixed access makes switching much less likely (the closest substitute is probably mobile access). Consumers who require broadband access are likely to be particularly inelastic to price of access (particularly, as noted in the Communications Report 2008, mobile broadband currently does not offer the speed of fixed broadband and users are subject to tighter capacity constraints).

International price comparisons

5.86 Another source of evidence on whether UK access and call prices are at their competitive level is comparisons with prices for equivalent services in overseas markets. If the UK market is competitive we would expect that UK consumers get a deal at least as good as that available to similar consumers overseas[59] as long as the underlying costs of provision are broadly similar. We have looked at the cost of UK fixed line services in relation to other countries using a comparison of international pricing produced by Ofcom in the Consumer Experience Report (see

[59] Because this analysis considers the whole UK it is more relevant to the UK area excluding Hull. It is unlikely to pick up any nuances relevant to just the Hull area.

http://www.ofcom.org.uk/research/tce/ce08/research.pdf). The methodology is as follows (for full details refer to the consumer experience report):

- We constructed four 'typical' household types that use fixed line telecoms, which collectively may be seen as representative of the average population across the countries considered. We then defined a usage level appropriate for each household type. These are illustrated below.

Table 5.12: Household types

Basket	Typical Household	Usage of fixed voice
1	A retired low income couple	Low
2	A couple of late adopters	Medium
3	A networked family	High
4	An affluent couple with sophisticated use	Low

Source: Ofcom

- In July 2008, details were collected of every tariff and every tariff combination from the largest three operators in each country by retail market share[60].

- Our model identifies the tariffs that offer the lowest price for each of the household baskets.

- All prices are converted back to UK currency using a Purchasing Power Parity (PPP) adjustment, based on OECD comparative price levels and the exchange rate in July 2008.

5.87 Prices for each country are calculated based on two measures:

- A weighted average of the best value tariffs from the three largest operators in each country; and

- A best offer basis which is calculated as the cheapest tariffs available from the three largest operators in each country.

5.88 Comparison of the overall weighted average prices (see figure 5.13 below) indicates that there is little difference between Germany, the UK, Italy and France - all of these countries are cheaper than Spain and the US. Overall, this would suggest that the UK market offers at least the same level of value as the comparator countries[61].

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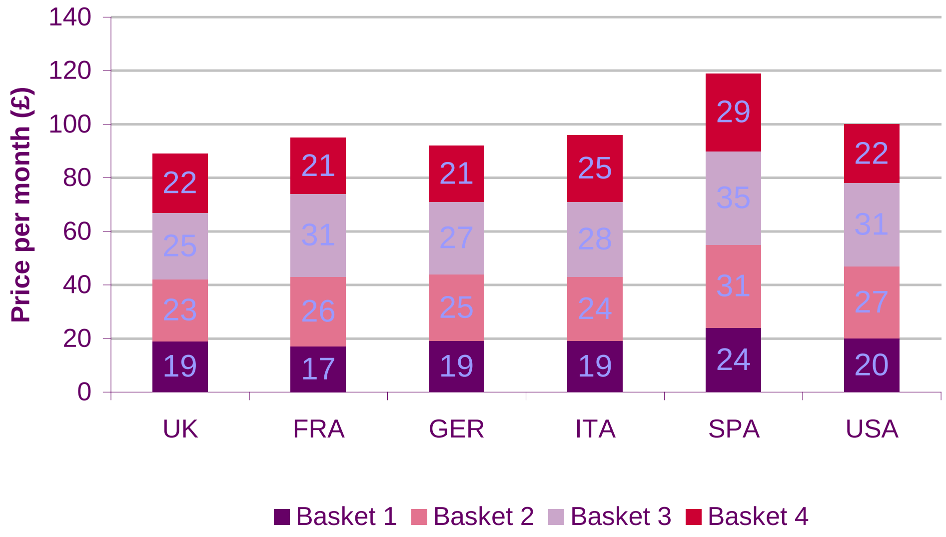
[60] Data from more than three operators was used if required to ensure that a minimum of 80% of the overall market was represented.
[61] Assuming constant quality.

Figure 5.13

Comparative weighted average fixed line voice pricing



Source: Ofcom using data supplied by Teligen

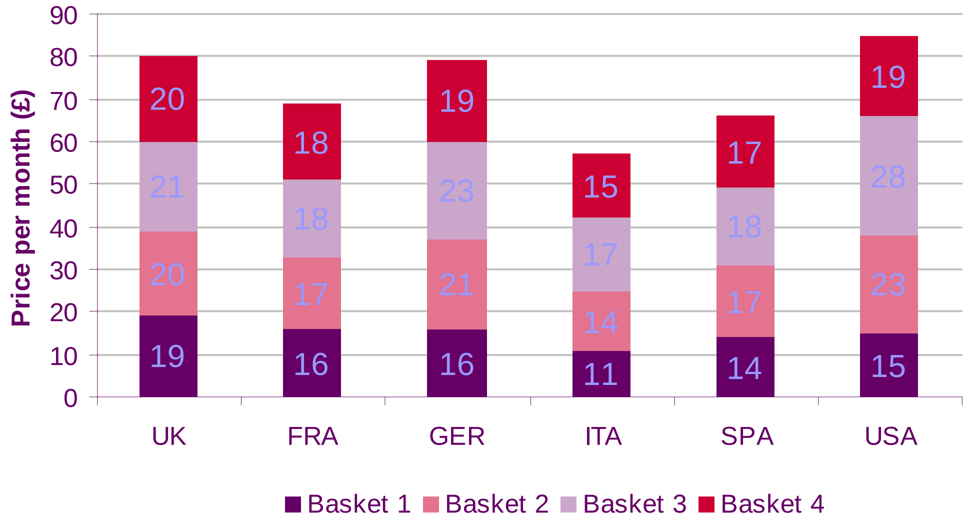
5.89 There are some notable differences between the baskets created by different tariff structures within the countries. The UK is more expensive than France for the low users (Baskets 1 and 4) as a consequence of having relatively high line rental charges. This is possibly because the international comparison did not take account of the BT Basic package which offers service at a reduced cost to eligible low income consumers.

5.90 The UK is cheapest for high users (Basket 3) due to the relatively low cost of purchasing enhanced tariffs or add-ons e.g. unlimited any-time national calls or reduced prices on international calls or calls to mobiles.

5.91 Looking at the best tariff available from the three largest operators in each country (figure 5.14 below) produces some striking differences from the weighted average analysis. While the 'weighted average' analysis is, to a considerable extent, a reflection of incumbent pricing (with incumbents having market share of over 60% of exchange lines in all countries), the 'best offer' analysis gives prominence to tariffs from the largest alternative network operators.

Figure 5.14

Comparative best offer fixed line voice pricing



Source: Ofcom using data supplied by Teligen

5.92 Despite offering second lowest overall prices for the group of countries considered on the 'weighted average' basis the UK has the highest overall prices of all the European countries when only the best tariff for each basket is considered. This is partly because of a much lower differential between the pricing of the incumbent and of the two largest alternative networks. Interestingly, the UK is the only country in which a tariff from the incumbent appears as a 'best offer' tariff for one of the baskets.

5.93 This suggests that alternative providers are not significantly undercutting BT's price offers. This could mean that BT is already pricing at a competitive level leaving little room for competitors to undercut prices. Alternatively it might indicate that competitors are content to follow BT's pricing e.g. using BT as a benchmark and offering differentiated services or slightly lower prices to attract customers.

5.94 Overall the analysis suggests that consumers in the UK are not paying significantly more for fixed telecoms services than the comparator countries, and that BT prices are closer to their competitors relative to other countries.

Forward look

UK area excluding Hull

5.95 BT faces pressure to keep access prices competitive from WLR/CPS, LLU and cable providers. This competitive pressure appears to be set to continue, with, for example, Sky announcing plans to invest in LLU.

5.96 Although customers are increasingly using mobile phones for calls, demand for fixed access has remained relatively strong, in part, to allow customers to access fixed line broadband (e.g. in our Consumer Market Research 26% of respondents agreed with the statement, "we only have a landline for internet access.") BT and the other providers of fixed broadband appear to have faced only limited competitive pressure from mobile broadband to date.

5.97 Fixed to mobile substitution may increase over time e.g. more people are likely to move to mobile only access as mobile broadband increases in quality and reduces in price, reducing the reliance on a fixed line for broadband. On the other hand, demand for fixed line access will remain strong if it is required for emerging products e.g. IPTV and for security reasons.

5.98 We do not think that a move to next generation networks (NGN) will have a significant impact on retail competition. NGN is unlikely to result in CPs building their own access infrastructure due to high investment costs. NGN should not have an impact on the wholesale remedies already in place which enable retailers to enter the market and compete at the retail level.

5.99 It is possible that fixed/mobile converged products (i.e. products which use fixed networks when located at the home base and mobile networks when away from home) will impose an additional competitive constraint on the fixed access market. However, it is not clear if use of these products will become widespread during the Review period.

Hull area

5.100 KCOM currently has a 100% share of the residential access market in the Hull area. Competitor entry is possibility in the future. However, there appears to be limited appetite to enter the Hull area. This means we believe that KCOM is likely to retain SMP for the period covered by this Review.

Conclusions on residential fixed analogue access

UK area excluding Hull

5.101 We consider that BT does not have SMP in the residential fixed analogue access market for the following reasons:

- The wholesale remedies have led to the development of products which enable competitors to replicate the services offered by BT without making significant infrastructure investments. This has lowered barriers to entry and growth.

- A wide variety of retailers have entered the market. For example, Sky has been able to add access, calls and broadband to its pay-TV packages and market to its existing customer base. As new firms have entered and expanded, BT's market share has fallen.

- Although BT's market share remains high, we believe that the intensity of competition from rival firms is strong and likely to increase. In particular, we believe that the variety of retailers and retail business models enables competitors to target a range of customers across BT's base.

- Some of the main competitors such as Sky are going to increasingly rely on LLU during the review period to further reduce their costs and increase the competitive pressure on BT.

- Consumers are willing and able to switch provider (evidenced by the fall in BT's market share).

- The overall cost of a fixed line access and calls package is similar (or lower) than in similar OECD countries.

Question 5.1 Do you agree with the analysis set out above for the residential analogue access markets in the UK excluding the Hull area which found that BT does not have SMP? If not, please provide reasons.

Hull area

5.102 We consider that KCOM does have SMP in the residential fixed analogue market for the following reasons:

- There are no significant competitors in the market.
- Threat of entry is somewhat muted.

5.103 With respect to the three tests for *ex ante* competition in relation to the Hull area, we are of the view that the market does not tend toward competition due to the presence of barriers to entry and a lack of competition in the market. Therefore the Commission's first two tests are not satisfied.

5.104 In addition, we do not think that competition law alone is enough to address the SMP in this market as the entry barriers are too high and have proved to be effective in excluding competition. Therefore it is appropriate to impose *ex ante* regulation on the market.

Question 5.2 Do you agree with the analysis set out above for the residential analogue access markets in the Hull area which found that KCOM continues to have SMP? If not, please provide reasons.

Business Markets for fixed analogue access

5.105 Many of the features of the business market are common with the residential market. In the analysis that follows, rather than repeat our residential analysis we instead highlight the areas where the structure and nature of competition in the market differ significantly.

Regulatory developments since the 2003 review – UK area excluding Hull

5.106 In 2007 Ofcom published a document entitled, "Replicability: the regulation of BT's retail business exchange line services"[62] which consented to revoke some of the SMP regulations for the large business market (those with an annual spend with BT in excess of £1million per year on a projected basis). The consent was granted on the basis that the wholesale inputs were of a sufficient standard to enable other communication providers to offer retail services that were commercially and technically replicable to those BT might offer.

5.107 This was in response to requests from BT and business users to allow BT to respond to the demands of individual customers by offering unpublished bespoke prices for services in the business retail market. At the time we recognised that the publication of prices and the provision of services on terms that do not discriminate unduly can lead to price following and mean that BT's ability to tailor packages is limited. This can mute competition and is not in the consumers' interest.

5.108 We also noted that we would consider extending the consent to all customers of business line services (i.e. including those with a projected annual spend with BT below

[62] http://www.ofcom.org.uk/consult/condocs/draftconsent/

£1million) should we consider that the WLR provision was sufficient to allow other communication providers to offer replicable services to BT and on the proviso that:

- Bespoke prices do not fall below a price floor which covers transfer charges for network components plus fully allocated retail costs; and
- BT assess each bespoke price for compliance with the Competition Act 1998 and any *ex ante* safeguard tests, and to demonstrate that it has adequate management systems to ensure compliance

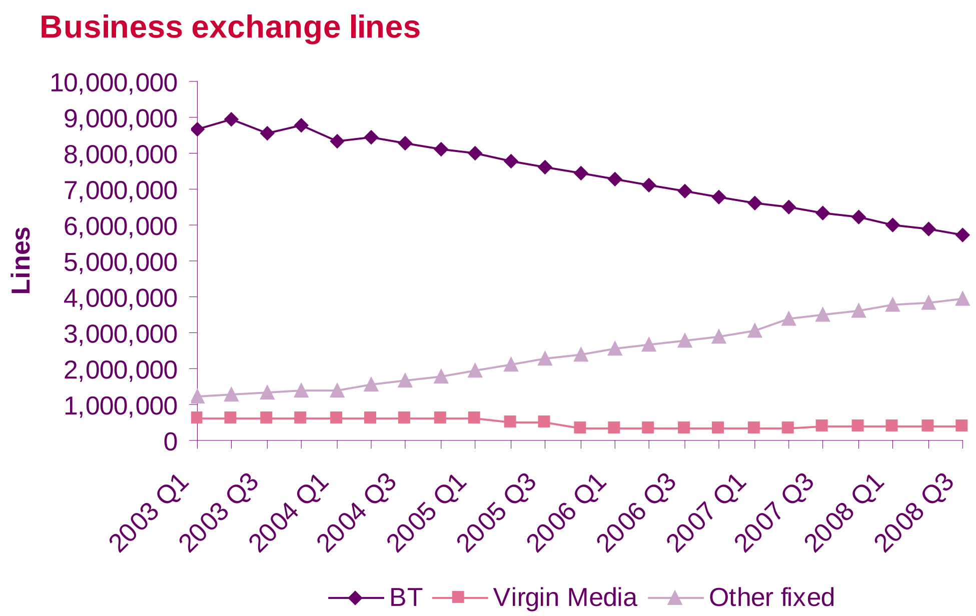
5.109 We do not consider that the competitive conditions in the large business market have deteriorated since the relaxation of SMP regulations nor have we received any complaints that BT is exploiting customers in this market.

Market Shares

UK area excluding Hull

5.110 The total number of business analogue exchange lines has declined slowly since 2003, from 10.8 million to 10.1 million in Q3 2008.

Figure 5.15



Source: Ofcom/operators

5.111 However, BT's share of exchange lines has fallen dramatically from 82% in 2003 to 57% in Q3 2008. Virgin's share of the business market has also fallen as rival retailers using WLR/CPS and LLU have increased their market share from 13% to 39%.

5.112 BT's market share by revenue has fallen by a similar amount, from 87% in 2003 to 65% in Q3 2008. One possible reason why BT's market share by revenue has been higher than their exchange line market share is that many SME's use BT as a secondary access line to obtain greater perceived security of supply.

Table 5.16 Market shares of business fixed narrowband access

	Exchange Lines			Revenues		
	BT	Virgin	Others	BT	Virgin	Others
2003	82%	6%	13%	87%	3%	10%
2004	77%	6%	17%	84%	2%	14%
2005	73%	4%	23%	80%	2%	18%
2006	68%	3%	29%	74%	3%	23%
2007	61%	4%	35%	69%	2%	28%
2008 Q1	59%	4%	37%	66%	2%	31%
2008 Q2	58%	4%	38%	65%	2%	33%
2008 Q3	57%	4%	39%	65%	2%	33%

Source: Ofcom/operators

Hull area

5.113 There are no WLR or LLU providers serving business customers in Hull (as evidenced by KCOM's Regulatory Financial Statements reporting zero external sales for business analogue exchange line services).

5.114 Some CPs offer fixed exchange line services by alternative means (e.g. leased lines or fixed radio access). These alternatives are only likely to be economically attractive for larger businesses.

5.115 The number of business analogue exchange lines provided by KCOM (shown in the table below) has declined slowly which suggests that substitution to mobile access or other alternatives is limited.

Table 5.17 Business exchange lines provided by KCOM

	2006/7	2007/8
Number of business exchange lines	62003	60651
% change over previous year	-1%	-2%

Source: KCOM Regulatory Financial Statements year ended 31 March 2008

5.116 The high market share of KCOM creates a presumption of significant market power.

Barriers to entry and expansion

UK area excluding Hull

5.117 Barriers to entry in the business market are very similar to those in the residential market, with the development of WLR/CPS and LLU now making it relatively easy for new retailers to enter the market and quickly win market share. There are, however, some differences.

5.118 Notably, small scale entry is more feasible in the business market as customers are much more diverse and are more interested in purchasing bespoke or value added services. A number of relatively small players provide businesses with a package of services including telephony, data services and business support.

5.119 For security (and other reasons) businesses may also have more than one access provider and this ‘multi-sourcing’ facilitates smaller scale entry. This contrasts with the residential market where the ability to cross-sell access and call products to an established customer base is more important.

5.120 Overall, barriers to entry and expansion are relatively low in the business market. However, the features of the business market means that new entrants are more likely to be small CPs, compared to the large retailers who have entered the residential market.

Hull area

5.121 As noted above, it may be feasible for CPs to offer larger businesses fixed line services by alternative means (e.g. leased lines). However, there are no operators offering WLR or LLU services. As noted in the residential section, the prospect of significant entry in these areas appears muted.

Customer switching costs and the intensity of competition in the market

UK area excluding Hull

Rivalry between BT, other fixed, and cable operators

5.122 In general, businesses are likely to have a greater degree of awareness regarding options for switching telecoms provider than consumers. Our SME research showed that 65% of businesses were aware that some telecoms providers offer businesses negotiable tariffs. This was the case for even the smallest companies - 64% of companies with 1-9 employees were aware of negotiable tariffs. Businesses are potentially more likely to be aware of the benefits of shopping around than consumers.

5.123 Although retailers tend to be smaller companies they do appear to be competing intensively with BT, and are successful in winning market share. BT’s internal research suggests that no one firm is a particular close competitor, but rather BT are losing market share to a large and varied number of companies.

5.124 The other important feature of the business market is that SMEs of all sizes tend to multi-source. Research indicates a significant proportion of all firms multi-source. This can lead to intensive competition both “for” the market, and “in” the market. In addition, because large businesses will already have a relationship with several telecoms providers barriers to switching are likely to be lower.

5.125 BT often appears to be used as a secondary access supply adding to an increased perceived security of supply. This has ambiguous effects on the intensity of competition. On the one hand, BT’s reputation for security of supply may soften competition if businesses feel that they have to have a BT line. On the other hand, BT will still be forced to compete intensively to be used as the primary supplier.

Actual behaviour

5.126 SMEs appear more likely to have switched in the past than residential consumers e.g. BT’s market share of business exchange lines is 9% lower than their residential market share.

5.127 In our research 26% of SMEs agreed that they, “change Communications Providers as often as they can in order to get the best deals” - interestingly this was slightly higher for the smallest companies with 1-9 employees (28%). This suggests that SMEs are engaged in the competitive process and willing to switch.

5.128 However, some of the results suggested that communications spend was not a high priority, e.g. 63% agreed that “Communications spend is only a small proportion of overall overheads so the company is pretty relaxed about its cost”. Again, this was a more common response from the smallest businesses. This might suggest that small businesses are less likely to invest time in researching the alternative suppliers or indicate that small businesses are content with their communications spend.

Hull area

5.129 As noted above, there are few alternative suppliers in the Hull area (and most alternatives are only feasible for larger businesses) thus there is little scope for switching.

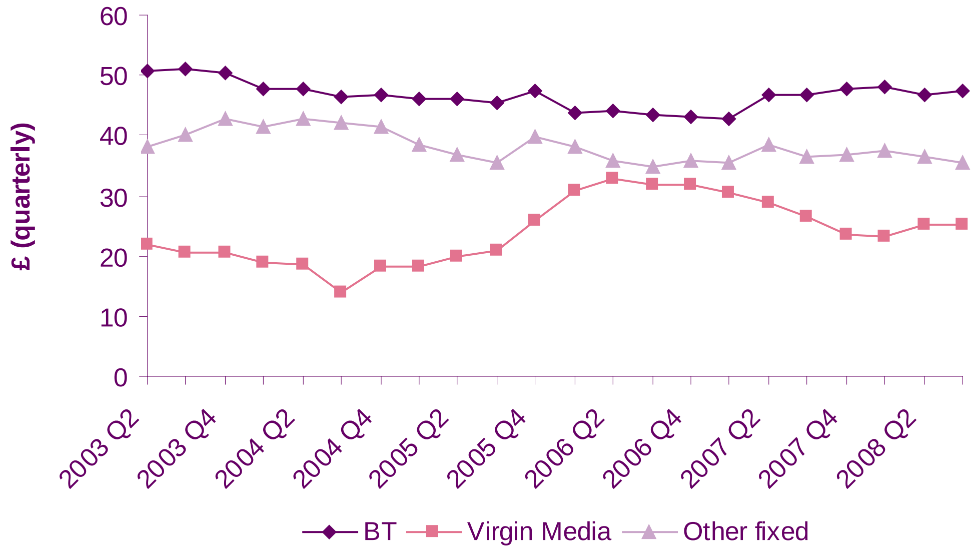
Pricing and profitability

UK area excluding Hull

5.130 BT’s business access price, as measured by access revenue per exchange line, has generally fallen throughout the period of this review, and is lower in 2008 relative to 2003 (in nominal terms). Throughout the period BT’s revenue per exchange line has been greater than for their competitors. This could reflect a premium for BT’s brand (e.g. perceived security of supply), greater customer inertia, or a greater success in offering value added access services.

Figure 5.18

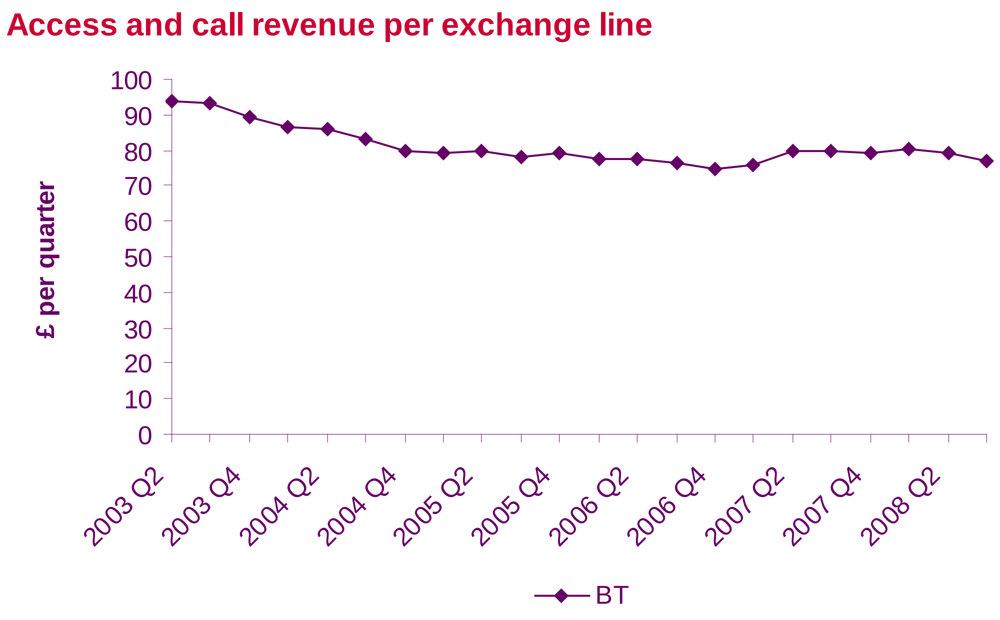
Business access revenue per access line



Source: Ofcom/operators

5.131 We have also looked at BT's total revenue per exchange line (access and calls revenue combined) – see figure below[63]. The figure shows that revenue per line has generally decreased since the last Review with a slight increase since 2006.

Figure 5.19



Source: Ofcom/operators

Hull area

Profitability

5.132 KCOM's return (turnover minus costs) on business exchange line services in Hull was slightly higher in 2008 at £3,166,000 (+1%) relative to 2007. The return on mean capital employed remained constant at 13% in 2008.

Pricing

5.133 KCOM's business access price, as measured by access revenue per exchange line, is shown in the table below:

Table 5.20 KCOM access revenue per business exchange line

	2003	2004	2005	2006
Annual access revenue per exchange line (£nominal terms)	126	133	119	125
% change over previous year	3%	6%	-11%	5%

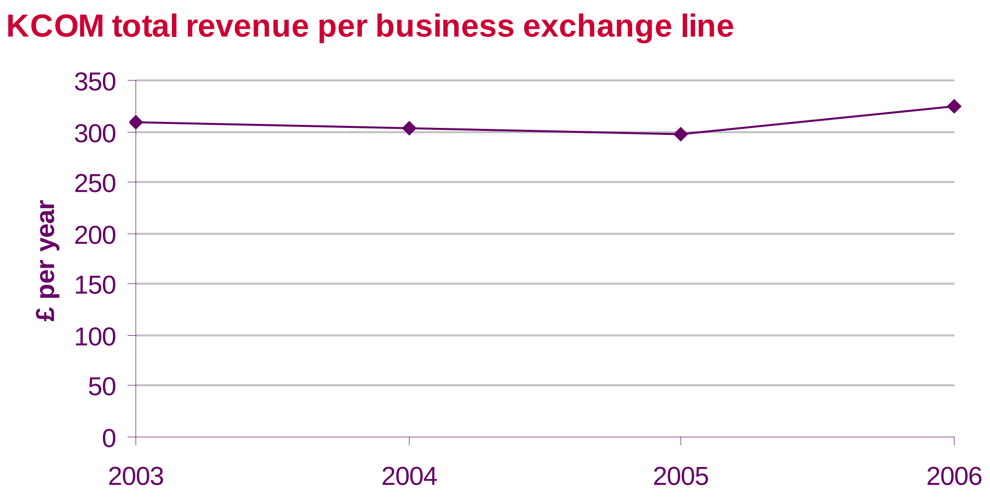
Source: S135 information provided by KCOM. Note 2007 has been excluded due to data quality issues.

[63] Virgin and Other fixed providers are not reported due to data quality issues.

5.134 Access revenue per exchange line has fluctuated over time but was at a similar level in 2006 relative to 2003.

5.135 The figure below shows KCOM's total revenue (access and calls[64]) per business exchange line in nominal terms. Total revenue per line declined from 2003-2005 but increased in 2006. However, total revenue per exchange line has only increased by 6% in nominal terms from 2003-2006.

Figure 5.21



Source: S135 information provided by KCOM. Note 2007 has been excluded due to data quality issues. Calls types included are geographic, international and call to mobile.

Other competitive constraints (including strategic pricing and dynamic issues)

UK area excluding Hull

5.136 As in the residential sector, the ability of BT to raise the price of access may be limited to some extent by the fact that high prices for access are likely to reduce the demand for BT calls, broadband, and other communication products. The extent of this indirect competitive constraint may well be greater in the SME market given the greater opportunity to cross-sell value added communications products to SME's who purchase access.

Hull area

5.137 As noted in the residential section, demand for calls and broadband may be relevant when pricing access. However, the lack of alternative providers for fixed access makes switching much less likely so the competitive constraints are less intense than the rest of the UK.

[64] The call types included are geographic, international and call to mobile.

Forward look

UK area excluding Hull

5.138 Competition in the business market is arguably more developed than in the residential sector and BT has lost market share at a quicker rate. While BT continues to lose market share of exchange lines at a rate of approximately 4% per annum, we might expect BT's market share to stabilise earlier than in the residential market, particularly if many businesses continue to use BT as a secondary provider of access.

Question 5.3 Do you agree with the analysis set out above for the business analogue access markets in the UK excluding the Hull area which found that BT does not have SMP? If not, please provide reasons.

Hull area

5.139 The prospect of entry in Hull appears muted thus we anticipate that KCOM will continue to have a high market share of business exchange lines.

Question 5.4 Do you agree with the analysis set out above for the business analogue access markets in the Hull area which found that KCOM continues to have SMP? If not, please provide reasons.

Conclusions on fixed business analogue access

UK area excluding Hull

5.140 We consider that BT does not have SMP in the business fixed analogue access market for the following reasons:

- The wholesale remedies have led to the development of products which enable competitors to replicate the services offered by BT without making significant infrastructure investments. This has lowered barriers to entry and growth.
- New firms have entered and expanded in the market resulting in a fall in BT's market share. BT's market share of exchange lines has fallen by 25% since the last review and now stands at 57%.
- Some SMEs dual source, and this has increased the opportunities for new entrants to establish themselves. While competition appears quite fragmented, small scale entrants do appear to be highly effective in competing head to head with BT – BT has lost market share to a large number of smaller companies.
- Relaxation of the SMP regulations in 2007 for large businesses appears to have been successful.

Hull area

5.141 We consider that KCOM does have SMP in the business fixed narrowband analogue access market for the same reasons set out for the residential access market (refer to 5.102 to 5.104 above).

ISDN2

Market Shares

UK area excluding Hull

5.142 At the time of the 2003 market review, retail competition in the supply of business ISDN2 lines was undeveloped. BT had a market share of 99% of lines and faced only limited competition from cable operators. Competition was, however, expected to increase as businesses increasingly switched to IP based solutions for their voice and data needs.

5.143 Although some businesses have switched to IP based solutions, the size of the ISDN2 market has remained relatively constant over the past five years. One of the main reasons for this is that the nature of ISDN2 use has changed. Whereas in 2003 ISDN2 was used primarily for voice, increasingly many businesses are now using ISDN2 as a back-up for their data management systems.

5.144 While competition from IP based solutions may have been less than anticipated, competition within the ISDN2 market has increased. Notably, the development of WLR has allowed a number of smaller Communications Provider re-sellers to enter the market, offering a competing product to BT. As a consequence, BT's market share has fallen progressively and now stands at approximately 73% of connections.

5.145 BT's revenues have decreased by £25M over the period from 2002 to 2007. We have been unable to provide a reliable estimate of BT's market share by revenue. However, it is likely to be slightly higher than its channel market share as rival re-sellers often offer discounts on BT's published tariffs.

Table 5.22 BT's ISDN2 market share (channels) and rental revenues

	2002	2003	2004	2005	2006	2007
BT channels ('000s)	1,194	1,218	1,179	1,120	1,037	1,019
WLR Re-seller channels ('000s)	34	60	124	190	279	370
BT share of channels	97%	95%	91%	86%	79%	73%
BT rental revenues	✂	✂	✂	✂	✂	✂[65]

Source: BT response to S135 request (data excludes Virgin which we estimate to be less than 1% market share)

Hull area

5.146 There are no WLR ISDN providers serving business customers in Hull (Kcom's Regulatory Financial Statements 2008 report zero external sales for ISDN2).

[65] Information redacted as commercially confidential

5.147 Some businesses obtain ISDN2 services by alternative means (e.g. leased lines or self provide). These alternatives are only likely to be economically attractive for larger businesses.

5.148 The number of business ISDN2 lines provided by KCOM (shown in the table below) has declined since 2006 reflecting a continued trend away from traditional circuits.

Table 5.23 KCOM ISDN2 exchange lines

	2006/7	2007/8
Number of ISDN2 exchange lines	2351	2293
% change over previous year	-4%	-2%

Source: KCOM Regulatory Financial Statements year ended 31 March 2008

Barriers to entry and expansion

UK area excluding Hull

5.149 WLR has reduced barriers to entry since the last Review. In particular, WLR allows CPs to offer a retail ISDN2 product without any significant physical investment. It is relatively simple to add an ISDN2 product to the existing range of products, and the incremental cost of doing so is likely to be modest. Regulated wholesale access prices also allow new entrants to obtain the same access price as BT providing a level playing field.

5.150 However, in practice barriers to entry and expansion remain. ISDN2 tends not to be purchased in isolation but as part of a suite of business products/services. The opportunity to market ISDN2 to a new customer will often be at the time that they are considering changing communications provider or reviewing their communications needs. To win ISDN2 market share quickly, firms may well need to offer a whole range of attractive communication products which makes entry and expansion more difficult. It is possible for businesses to just change their ISDN2 supplier. However, this means contracting with an additional Communications Providers (with an additional bill), which is often unattractive given the limited financial gains of switching supplier.

5.151 It can be difficult and costly to reach ISDN2 customers because ISDN2 is purchased by a minority of businesses. In contrast, in residential access markets large retailers were able to win market share quickly by marketing access – a product that most customers purchase - to their established customer base.

5.152 There has been substantial entry into the ISDN2 market, with over 400 re-sellers now offering ISDN2 products. However, many of these re-sellers serve only a handful of customers, and no new entrant has managed to achieve a market share in excess of 3%.

Hull area

5.153 As noted above, it may be feasible for CPs to offer larger businesses ISDN2 services by alternative means (e.g. leased lines). However, there are no operators offering ISDN2 via WLR. The prospect of significant entry the ISDN market appears muted, particularly as there is a trend away from using traditional circuits towards alternative technologies.

Customer switching costs and the intensity of competition

UK area excluding Hull

Switching costs

5.154 The cost of installing a new ISDN2 line varies[66] e.g. BT charges £299 connection charge for the "low start" package and £249 connection charge for the "start up" package (exc VAT). This is a relatively high in relation to line rental costs. For example, on a standard 3 year low start BT contract, the connection charge represents 21% of the total cost of an ISDN line over 3 years[67].

5.155 The cost of switching from an analogue exchange line to ISDN2 is relatively high (e.g. BT charges £199-£249) but the costs of switching from one ISDN2 provider to another are relatively modest. Openreach's wholesale charge to switch provider (on a like for like basis) is only £11.30 excluding VAT, and many retailers choose to offer free connection charges for customers who already have ISDN2 installed.

5.156 While the financial costs of switching between CPs are low, there are likely to be transaction, search and other administrative costs. As ISDN2 is often purchased as an ancillary service to other voice and data needs, changing supplier could often lead to the inconvenience of having to deal with multiple CPs, e.g. multiple bills.

5.157 Although these costs may be small in absolute terms they may well be high relative to the financial benefits of switching. ISDN2 is essentially a homogenous product, so the principal benefit of switching would be to obtain a lower price. While rival re-sellers frequently offer discounts off BT's price published price list, a discount of (say) 10% on the quarterly rental and a reduced connection fee of £23 would result in a saving of £440 over the course of a three-year contract relative to BT's standard "low start" rates[68].

5.158 Consistent with the incentives described above, to date there is limited evidence of business customers switching between CPs in order to obtain a better deal. While BT has lost market share to rival re-sellers, BT's rivals appear to be primarily picking up new business as opposed to winning customers from BT. We estimate that rival re-sellers are now winning around 50% of new business. Despite the increase in competition, BT's customer base has remained relatively stable with the number of BT connections down only 15% since 2002. Moreover, BT's customer churn[69] has decreased significantly from 31% in 2004 to 21% in 2007.

5.159 BT's customer churn reflects both customers switching to rival ISDN2 re-sellers as well as switching to IP and perhaps analogue voice and data solutions. Although we do not have direct evidence on the proportion accounted for by switching between different providers of ISDN2 we note that the collective churn of re-sellers using WLR is comparable to BT's at 24%. As we would only expect a small proportion of customers to be switching back to BT, this might suggests that the overwhelming majority of switching experienced is customers switching out of ISDN2 to other voice and data products.

[66] The wholesale installation price charged by Openreach is £233 exc VAT. Some CPs offer free connection, although their rental charges are often higher than those available elsewhere.
[67] Based on BT's quarterly ISDN2 line charge of £95.85 exc VAT for a 3 year contract and a connection charge of £299 exc VAT.
[68] Based on BT's low start quarterly ISDN2 line charge of £95.85 with a £299 connection fee.
[69] The number of customers BT loses each year as a % of its customer base.

Intensity of competition

5.160 BT is currently subject to two SMP remedies for the ISDN markets (no undue discrimination and price publication). These remedies restrict BT from offering bespoke pricing to a customer without being forced to offer it to all customers and also ensure that all its packages are visible to competitors and customers.

5.161 The general objectives of these remedies is to allow competitors to enter the market with confidence in the charges the incumbent sets and to prevent the incumbent selectively undercutting new entrants.

5.162 Because BT is obliged to publish its tariffs there may be a reduced incentive for BT to cut prices because rivals are likely follow any price reduction. This disincentive to compete may have contributed to a situation in the market where BT has been able to increase prices in the last two years with no commensurate loss of revenue or market share (see discussion below).

5.163 Overall, while smaller firms are able to compete with BT and win small amounts of market share, there appears to be little incentive for BT to respond to this competition by lowering its prices to business consumers (at least partially because of the remedies currently in place – see discussion in Section 7 below). The market structure is characterised by a single dominant player with a number of competitors with low individual market share.

Hull area

5.164 As noted above, there are few alternative suppliers in the Hull area (and most alternatives are only feasible for larger businesses) thus there is little scope for switching.

Profitability and pricing

UK area excluding Hull

5.165 The ISDN2 market has been characterised by little movement in retail price despite a reduction in the wholesale price in 2004. BT held their rental prices constant from 2002 until 2007 at £93/quarter (ex vat) for a two channel ISDN2 line[70], followed by a price increase of 4.8% in November 2007 and 3.5% in 2008 (see table below).

5.166 Wholesale ISDN2 prices were reduced significantly on 1st October 2004 from £71.81 to £55/quarter, but have since remained constant.

[70] BT's one year contract low-start tariff. Other tariffs have changed at similar times and at similar rates.

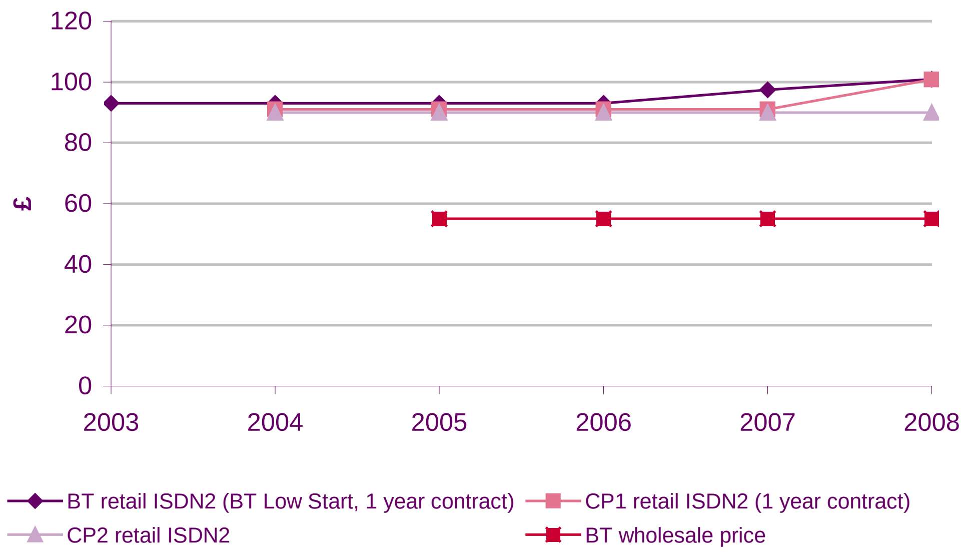
Table 5.24 BT ISDN2 prices

ISDN2e rental per quarter exc. VAT per contract term	1 yr	3yr	5yr
Previous price			
Low Start	93.00	88.35	83.70
Start Up	142.00	134.90	127.80
Call Plan	195.00	185.25	175.50
1st November 2007			
Low Start	97.47	92.60	87.72
Start Up	148.80	141.36	133.92
Call Plan	204.36	194.14	183.92
1st November 2008			
Low Start	100.89	95.85	90.78
Start Up	154.02	146.31	138.60
Call Plan	211.50	200.94	190.35

Source: BT

5.167 The evidence we have gathered from other CPs suggests that the standard market tariffs for rental and connection are little changed since the last Review (see figure 5.25 below) – which might suggest a low intensity of competition.

Figure 5.25 ISDN2 standard rental per line per quarter compared to wholesale charge



Source: Operators

5.168 BT's margin over wholesale access costs has increased substantially over the period. BT did not pass any of the reduction in wholesale access prices on to consumers in 2004, and in 2007 and 2008 retail prices increased with no change in wholesale access costs. The net effect of this is that BT's price cost margin[71] has increased from 23% in 2003 to 45% in 2008 (based on a 1 year low start tariff).

5.169 If competition in the ISDN2 market is effective we might have expected to see BT's margins between its retail and wholesale price decreasing rather than increasing. We do, however, need to exercise care in interpreting these figures. For example, the

[71] Price cost margin = (Retail Price – Wholesale access cost)/ Retail Price

increase in rental margins may have been compensated for by falling margins elsewhere e.g. on connection charges or calls.

Hull area

5.170 KCOM's prices are broadly similar to BT's as shown in the table below:

Table 5.26 KCOM and BT annual ISDN2 rental charges

	1 year contract	3 year contract	5 year contract
BT ISDN2 low start package line rental exc VAT per year	£403.56	£383.40	£363.12
KCOM ISDN2 National line package line rental per year[72]	£400.44	£385.08	£372.72

Source: http://www.KCOM.com/eastyorkshire/pricemanual/business-main.asp and BT

5.171 KCOM's return for ISDN2 exchange lines (turnover minus costs) declined by 3% in 2008 relative to 2007[73]. The return on mean capital employed remained constant at 13%.

Other competitive constraints (including strategic pricing and dynamic issues)

UK excluding Hull

5.172 ISDN2 lines are usually sold as part of a package of business services and ISDN2 prices are not the focal point of competition. There therefore appears to be limited incentive to price ISDN2 products low in order to drive demand for complementary products.

5.173 As ISDN2 is nearing the end of its life-cycle the incentives to invest in low prices to gain market share are likely to be limited. There are three possible reasons for this:

- With increasingly fewer customers to compete for, low prices are less likely to result in increases in sales, but instead will simply benefit existing customers;

- As customers migrate to IP based products, those customers that continue to purchase ISDN2 may be less price sensitive; and

- There may be an incentive to keep ISDN2 prices high in order to encourage customers to migrate to IP solutions if, in doing so, higher margins are likely to be earned in the future.

Hull area

5.174 As noted above, there is likely little incentive to keep ISDN2 prices low to drive demand for other products. The limited number of alternative providers for ISDN2 means competitive pressures are limited.

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[72] Based on 1-50 lines taken with payment by invoice.
[73] Source: KCOM Regulatory Financial Statements year ended 31 March 2008

Forward look

UK area excluding Hull

5.175 BT is likely to face increased competition in the future both from rival WLR based re-sellers of ISDN2 and from businesses migrating to IP based solutions.

5.176 To date, WLR re-sellers have been successful in winning market share, although there is little evidence that they have imposed a particularly strong competitive constraint on BT's prices and margins. There seems no reason to suppose that the structure or nature of competition in the market is likely to change in the immediate future, not least because the ISDN2 product appears to be moving towards the end of its life-cycle so that there is little incentive for new entrants or other retail competitors to BT to make major investments aimed at winning market share.

5.177 We would expect competition from IP based products to increase leading to a progressive decline in the size of the ISDN2 market. However, as there is likely to be limited incentives or ability to resist this trend (which is in any event unlikely to be affected to any significant extent by ISDN2 prices), we would not anticipate that this would lead to any significant increase in the competitive constraints on BT.

Hull area

5.178 As above, we would expect the ISDN2 market to decline as companies migrate towards IP based products. However, we do not anticipate any significant increase in the competitive pressures in the ISDN market in the Hull area. Entry is unlikely in a product nearing the end of its lifecycle.

Conclusions on ISDN2 access

UK area excluding Hull

5.179 We consider that BT continues to have SMP in the ISDN2 access market for the following reasons:

- BT's continuing high market share combined with apparently increasing retail margins.
- The absence of significant competitors, and apparent barriers to expansion.
- While entry has increased, there is little evidence that this has resulted in lower prices to businesses. BT's retail prices have remained stable in nominal terms until 2007 (while wholesale prices decreased), followed by two nominal price increases of around 4.8% in 2007 and 3.5% in 2008.
- There are a number of reasons that appear to have contributed to the limited increase in competition. These include:
  - ISDN products are often ancillary to a voice/data solution, and don't provide the focal point of competition.
  - BT is obliged to price uniformly off its rate card, so there is little incentive for BT to reduce prices because rivals are likely to follow.

- o It is difficult for retailers to differentiate themselves from BT. Incentives to invest in price cutting and in retailing more generally are limited by the limited demand for new products and the progressive switch to IP based solutions.

Question 5.5 Do you agree with the analysis set out above for the ISDN2 market in the UK excluding the Hull area which found that BT continues to have SMP? If not, please provide reasons.

Hull area

5.180 We consider that KCOM continues to have SMP in the ISDN2 access market for the same reasons set out for the residential access market (refer to 5.102 to 5.104 above).

Question 5.6 Do you agree with the analysis set out above for the ISDN2 market in the Hull area which found that KCOM continues to have SMP? If not, please provide reasons.

ISDN30

5.181 ISDN30 is used primarily by businesses in conjunction with a private branch exchange (PBX) to provide value added voice services such as low price internal call, extension numbers and voice mail. In the UK excluding Hull ISDN30 access is provided by BT, Virgin Media, and re-sellers using WLR. In Hull ISDN30 is provided by KCOM and there is no WLR provision. CPs can bypass BT's or KCOM's fixed ISDN30 access by building networks out to the client, however, this is only likely to be economical for larger businesses.

Market Shares

UK excluding Hull

5.182 The ISDN30 market has remained relatively static in size over the last five years at around 3.3 million channels. The number of channels provided by BT has dropped by 12% between 2002 and 2007, giving it a market share of approximately 48%.

Table 5.27 BT's ISDN30 market share (channels) and rental revenues

	2002	2003	2004	2005	2006	2007
BT channels[74] ('000s)	1924	1987	1998	1929	1848	1745
Market Size[75]	3200	3300	3200	3100	3200	3600
BT share of channels	60%	60%	62%	62%	57%	48%
BT rental revenues	✂	✂	✂	✂	✂	✂[76]

Source: BT S135 response and Ofcom Communications Report 2008

5.183 We estimate that Virgin's share of the market currently stands at approximately 8%. The remainder of the market is accounted for by re-sellers providing ISDN30 access using either WLR, or by building out to client sites.

[74] Source: BT Response to section 135 request
[75] Ofcom, Communications Report, 2008
[76] Information redacted as commercially confidential

Hull area

5.184 As noted above, there are no WLR ISDN providers serving business customers in Hull (KCOM's regulatory Financial Statements 2008 report no external sales for ISDN30).

5.185 Some CPs offer ISDN30 services by alternative means (e.g. leased lines). These alternatives are only likely to be economically attractive for larger businesses.

5.186 The number of ISDN30 lines provided by KCOM (shown in the table below) has increased since 2006 reflecting a growing market.

Table 5.28 KCOM ISDN30 lines

	2006/7	2007/8
Number of ISDN30 exchange lines	1070	1144
% change over previous year	13%	7%

Source: KCOM Regulatory Financial Statements year ended 31 March 2008

Barriers to entry and expansion

UK area excluding Hull

5.187 As noted above for ISDN2, barriers to small scale entry are low. In particular, WLR allows CPs to offer a retail ISDN30 product without any significant physical investment. Regulated wholesale access prices also allow new entrants to obtain the same access price as BT providing a level playing field. There are over 300 companies providing ISDN30 via WLR.

5.188 However, as noted above, to win ISDN30 contracts firms may well need to offer a whole range of attractive communication products which makes entry more difficult.

5.189 Barriers to expansion and larger scale entry are likely to be more significant as ISDN30 is purchased by a minority of businesses making it more difficult and costly to reach customers.

Hull area

5.190 As noted above, it may be feasible for CPs to offer larger businesses ISDN30 services by alternative means (e.g. leased lines). However, there are no operators offering ISDN30 via WLR. The prospect of significant entry the ISDN market appears muted.

Customer switching costs and the intensity of competition

UK area excluding Hull

5.191 The market structure of ISDN30 differs from ISDN2 because, in addition to a competitive fringe of very smaller re-sellers, BT also faces competition from two significant competitors - Virgin Media and Cable and Wireless who have markets share of 8% and 12% respectively[77].

5.192 However, the intensity of rivalry in the market seems broadly similar to ISDN2. Specifically, there has been very little change in prices over the last five years or pricing

[77] Based on S135 information provided by CPs.

innovations. The overall picture is the same as ISDN2 with BT losing some sales mainly to WLR providers, but with no apparent effect on BT's prices or margins.

5.193 ISDN30 is often sold as an ancillary product to the more general voice and data needs of a business. CPs will often compete aggressively to win the general voice and data contracts and it is the overall pricing of these solutions, and not ISDN30 pricing, which is typically important in securing and the contract.

5.194 ISDN30 is a relatively homogeneous product and competition takes place largely on the basis of price. BT is obliged to publish prices and BT's competitors often compete by advertising discounts off BT's rate card. As BT knows that this is the form that competition takes, there is very little incentive for BT to compete aggressively by lowering its published retail prices.

5.195 One key difference from ISDN2 is the extent of competition from voice over broadband. For larger customers, switching to broadband using private networks requires investment in a new PBX (£50,000 to £100,000). Such a figure is only likely to be feasible for the biggest companies who make large numbers of internal calls and who operate on multiple sites.

5.196 However, the incentive to switch to a rival ISDN30 supplier may well be higher than in the case of ISDN2, largely because the benefits of making the switch are likely to be greater given the size of expenditure on ISDN30.

Hull area

5.197 As noted above, there are few alternative suppliers in the Hull area thus there is little scope for switching.

Other competitive constraints (including strategic pricing and dynamic issues)

5.198 The points noted above for ISDN2 also apply to ISDN 30. The ISDN30 market is likely to decline over time as businesses move towards IP based solutions. This is likely to happen slowly as PBXs reach the end of their useful lives. Since ISDN30 is nearing the end of its life-cycle the incentives to invest in low prices to gain market share are likely to be limited.

Profitability and pricing

UK area excluding Hull

5.199 As for ISDN2, BT's prices have increased by around 4.8% in 2007 and 3.5% in 2008 (see table below). While the retail price increases are relatively modest, the wholesale prices have remained constant since 2003 so price movements do not reflect increased costs.

Table 5.29 BT ISDN 30 prices

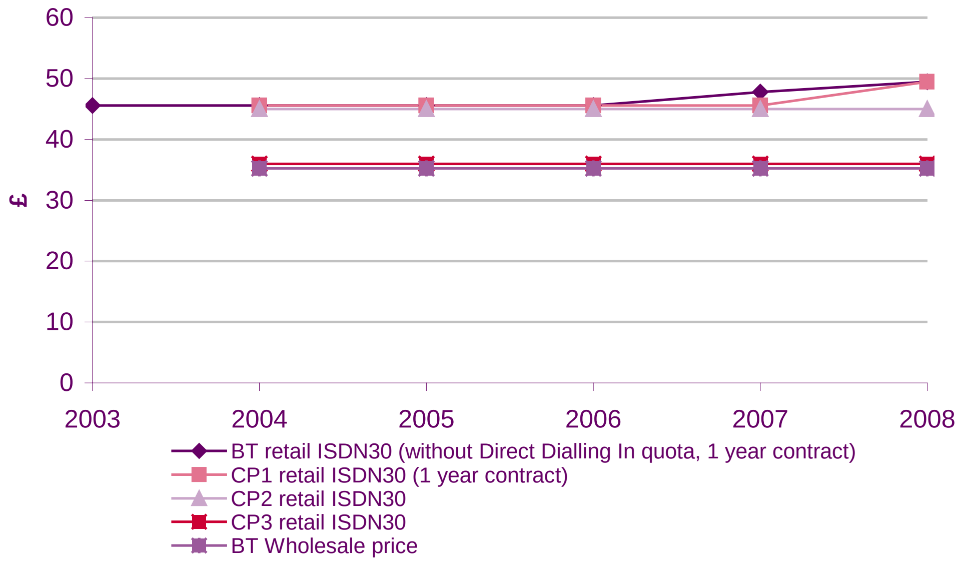
ISDN30 rental per quarter exc. VAT per contract term	1 yr	3 yr	5 yr
Previous price			
without Direct Dialling In quota	45.58	43.30	41.02
With quota	52.08	49.48	46.87
1st November 2007			
Without Direct Dialling In quota	47.76	45.37	42.98
With quota	54.57	51.84	49.11
1st November 2008			
Without Direct Dialling In quota	49.44	46.95	44.49
With quota	56.49	53.64	50.82

Source: BT

5.200 The evidence we have gathered from other CPs suggests that the standard market tariffs for rental and connection have seen little change since the last Review (see figure 5.30 below).

5.201 If competition was working we might expect to see prices decreasing since the last Review.

Figure 5.30 ISDN30 standard rental per line per quarter compared to wholesale charge



Source: Operators

5.202 As noted in the ISDN2 section, it is possible that the current SMP regulations on BT requiring price publication and no undue discrimination have dampened price competition.

<u>Hull area</u>

5.203 KCOM's ISDN30 prices are higher than BT's as shown in the table below:

Table 5.31 KCOM and BT annual ISDN2 rental charges

	1 year contract	3 year contract	5 year contract
BT ISDN30 rental with direct dialling quota exc VAT per year	£225.96	£214.56	£203.82
KCOM ISDN30 National line package line rental exc VAT per year[78]	£256.68	£250.56	£241.20

Source: http://www.KCOM.com/eastyorkshire/pricemanual/business-main.asp and BT

5.204 KCOM's return for ISDN30 exchange lines (turnover minus costs) increased by 11% in 2008 relative to 2007[79]. The return on mean capital employed remained constant at 13%. There appears to be little competitive pressure on prices or profits.

Forward look

UK area excluding Hull

5.205 Going forward we would expect the ISDN30 market to decline slowly as customers replace systems and switch to IP based solutions. We do not think that competition is likely to intensify given the factors outlined above.

Hull area

5.206 The ISDN30 market in Hull has grown over the past 2 years. We would expect this growth to slow as customers replace systems and switch to IP based solutions. We do not anticipate significant entry in this market therefore it is unlikely that competition is likely to intensify.

Conclusions on ISDN30 access

UK area excluding Hull

5.207 We consider that BT continues to have SMP in the ISDN30 market for the following reasons:

- Limited evidence of competitive pressure on BT's margins.
- While entry has increased, there is little evidence that this has resulted in lower prices to consumers. BT's retail prices increased in 2007 and 2008 despite constant wholesale prices.
- There are a number of reasons that appear to have contributed to the limited increase in competition. These include:
  - o ISDN products often ancillary to a voice/data solution, and don't provide the focal point of competition.

[78] Based on 1-100 channels taken (31-100 channels for 3 and 5 year contracts) with payment by invoice.
[79] Source: KCOM Regulatory Financial Statements year ended 31 March 2008

- BT is obliged to price off its rate card, so there is little incentive for BT to reduce prices because rivals are likely to follow.

- It is difficult for retailers to differentiate themselves from BT. Incentives to invest in price cutting and in retailing more generally are limited by the limited demand for new products.

Question 5.7 Do you agree with the analysis set out above for the ISDN30 market in the UK excluding the Hull area which found that BT continues to have SMP? If not, please provide reasons.

Hull area

5.208 We consider that KCOM continues to have SMP in the ISDN30 market for the same reasons set out for the residential access market (refer to 5.102 to 5.104 above).

Question 5.8 Do you agree with the analysis set out above for the ISDN30 market in the Hull area which found that KCOM continues to have SMP? If not, please provide reasons.

Section 6

Calls Markets – market power analysis

Introduction

6.1 The purpose of this assessment is to determine the effectiveness of competition in the various fixed narrowband calls markets, both currently and in the foreseeable future. This assessment will inform our decision as to whether retail fixed calls markets are competitive or that we consider that a single company holds significant market power (“SMP”).

6.2 Where we find a market to be competitive, there is no continuing requirement for company specific regulation (see Section 8). However, Ofcom’s involvement in the retail market will continue through sector level retail regulation, such as the General Conditions on communications companies (see Section 7).

6.3 Where SMP is found, we are obliged to consider what remedial regulations may be required to address the competitive failure.

Summary

6.4 Our conclusions in this section for the UK excluding the Hull area are:

- In the business and residential calls markets no company holds SMP;

6.5 Our conclusions in this section for the Hull area are:

- That KCOM holds SMP in the business and residential calls markets.

Our Approach

6.6 Our approach is the same as set out in Section 5. Many of the features of the calls market are common with the access market. In the analysis that follows, rather than repeat our access analysis we instead focus on supplemental evidence in the following areas:

- Market shares;
- Barriers to entry and expansion;
- Customer switching costs and the intensity of competition in the market;
- Prices and profitability.

6.7 In section 4 above, we have defined a single calls market each of residential and business customers. However, we recognise that within the markets the competitive dynamics may differ for each call type. For the UK area excluding Hull we present a further analysis for the main call types in Annex 5.

Relationship between the retail market definition and the Commission's Recommendation on relevant product and services markets.

6.8 Again, as set out in Section 5, we consider that EC's criteria are addressed within our assessment. Criterion 1 is covered with the discussion of barriers to entry and expansion. Criterion 2 is covered within the discussions of switching costs and the intensity of competition, market shares and prices and profitability. Criteria 3 is addressed only where we have identified market failure i.e. for the residential and business call markets for Hull – we will discuss this below.

Changes since the last review

6.9 In our last review in 2003 BT and Kingston were found to have SMP in each of the calls markets defined. Since that review there have been a number of regulatory and technological changes that have impacted upon competition particularly in the UK excluding Hull. Some of these relate principally to access markets and were discussed in Section 5. The remaining important charges were:

- Use of Carrier Pre-Selection (CPS) has increased (though now increasingly with WLR as part of a bundle of access and calls services), allowing customers to choose whether to have their calls delivered by BT or other CPs. In addition, BT now provides a competing Wholesale Calls product;

- Rival retailers can also provide fixed narrowband access through LLU including dedicated call services.

6.10 As noted in Section 5, because access and calls are closely linked in a number of cases the evidence we present relates to both products combined. Where this is the case the evidence is presented once in the access section to avoid repetition. For each calls market we consider separately the UK excluding Hull and the Hull area.

Residential Market for calls

Market Shares

UK area excluding Hull

6.11 In the table below we present BT's share of minutes and revenues for geographic, international and call to mobile combined. We have excluded 'other' calls because this category includes dial up internet calls[80]. BT's 'other' calls also includes calls made to non-BT internet service providers via FRIACO. Dial up internet calls have decreased rapidly as consumers have moved from narrowband to broadband internet access. Because BT's 'other' calls contained a proportionately larger number of dial up internet calls (due to FRIACO) the decline in dial up internet minutes will have a more significant impact on BT, and including 'other' calls would distort both the time series and cross Communications Provider comparison of market shares[81]. For information we present the market shares for all calls (including the other calls category) in annex 5.

[80] 'Other' calls also includes freephone, special services, premium rate, directory enquiries and all other call types (excluding geographic, international and call to mobile).
[81] That is, it could be incorrectly interpreted that BT's market share of minutes has fallen due to competition for voice minutes, when the actual cause is technological change which has made broadband a viable and attractive alternative to narrowband dial up internet.

Table 6.1 Market shares of residential calls - geographic, international and call to mobile

	Volumes			Revenues		
	BT	Virgin	Other fixed	BT	Virgin	Other fixed
2003	71%	18%	11%	69%	19%	12%
2004	65%	19%	17%	63%	20%	17%
2005	59%	19%	22%	56%	20%	24%
2006	54%	20%	26%	54%	19%	27%
2007	52%	18%	30%	55%	17%	27%
2008 Q1	49%	18%	32%	51%	18%	30%
2008 Q2	48%	18%	34%	53%	17%	30%
2008 Q3	47%	17%	36%	52%	17%	31%

Source: Ofcom/operators

6.12 Table 6.1 shows that BT’s share of minutes has fallen substantially since the last review – from 71% in 2003 to 47% in Q3 2008. Sales have been lost to other fixed providers offering calls via LLU, CPS, and wholesale calls with WLR. BT’s share of revenues has also fallen substantially, but to a lesser extent than minutes.

6.13 BT still has a high market share, but as noted in the access section, this does not necessarily indicate SMP e.g. because we would expect BT to retain a rump of inactive customers when products are homogenous and prices are similar. We expect the downward trend in BT’s market share to continue during the period covered by the market review as new competitors sell into their existing customer bases (e.g. Sky has 8 million customers who are not yet taking a talk product. In 2008 16% of Sky’s customers were taking a telephony product (up from 10% in 2007)).

6.14 The figures reported above largely exclude calls provided by VoB. The limited information we have on residential VoB calls suggests that they are currently a small part of the market. In June 2006 BT offered Broadband Talk as part of Total Broadband and now have circa 2 million registered users of the service, however, many of these customers may also use an analogue calls.

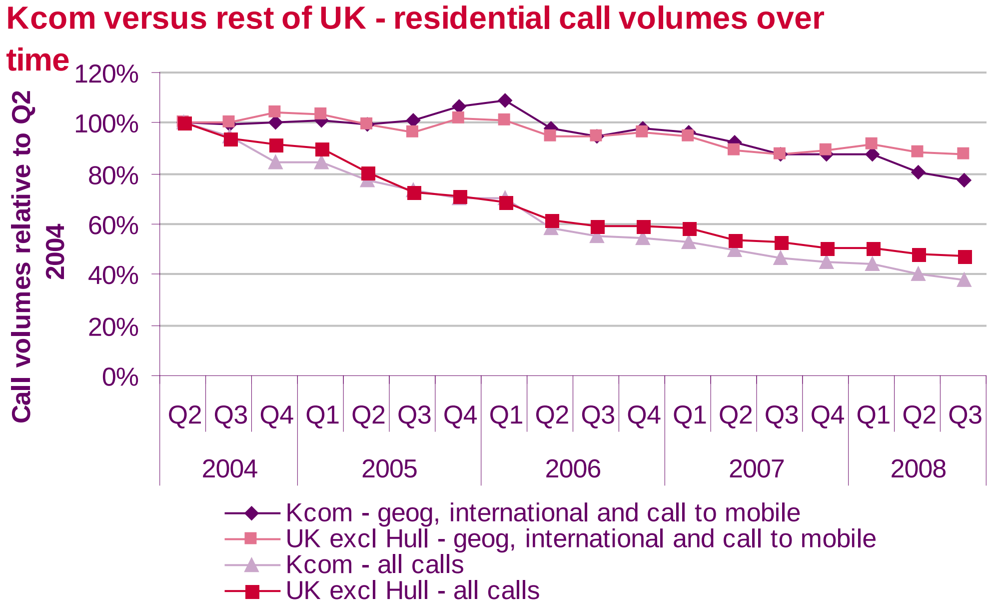
6.15 The substantial falls in market share since the last review suggest that competition is working in the market. This demonstrates that competitors are able to enter/expand and consumers are willing and able to switch and that the most plausible assumption is that this trend will continue during the period covered by the market review.

Hull area

6.16 The figure below shows how call volumes for KCOM and the rest of the UK (i.e. BT, Virgin and other providers) have changed over time relative to a base year (Q2 2004). The figure provides information separately for 1) geographic, international and calls to mobile and 2) all calls which includes 1) and all other call types (all dial-up calls to the internet are also included). As noted above, we would expect the ‘all calls’ volumes to have declined more steeply due to broadband take up leading to a reduction in the volume of dial up internet calls.

6.17 Since 2006 there has been a decline in the volume of geographic, international and call to mobile minutes which reflects substitution to other means of communication e.g. mobile calls and email. The decline in KCOM’s volumes is very similar to the rest of the UK which suggests substitution from fixed calls to other communication products is similar in Hull and across the rest of the UK. KCOM appears to have lost call volumes at a slightly higher rate over 2008.

Figure 6.2



Source: KCOM/operators/Ofcom

6.18 There is little evidence that wholesale remedies have been implemented in the Hull area. There are no residential CPS providers and KCOM's Regulatory Financial Statements (year ending 31 March 2008) report that less than 5% of call origination revenues[82] are derived from external sales e.g. IA.

6.19 Information provided by KCOM on average monthly minutes from February 2008 to January 2009 shows that indirect access minutes[13] are 10% of total outbound minutes. We are not aware of other operators offering calls in any volumes over their own infrastructure to residential customers so this suggests that KCOM's share of the fixed call market is at least 90% (by volume).

6.20 The high market share of KCOM creates a presumption of dominance.

Barriers to entry and expansion

UK area excluding Hull

6.21 As noted above, the number of residential WLR and LLU lines has increased substantially since 2004. The uptake of wholesale calls and CPS is reflected in the decrease in BT's share of fixed call minutes. Substantial take up of regulated call products by a number of operators suggests that barriers to entry and growth have materially reduced since the last Review.

Hull area

6.22 Despite the potential to develop wholesale products there are currently no WLR providers in the Hull area. There are a few IA providers but they account for less than

[82] This includes residential and business customers.

5%[83] of total call origination revenues and 10% of outbound minutes in the Hull area. Appetite to enter the Hull market appears limited, although it would be possible to offer CPS services in the Hull area without incurring the large sunk costs of building networks. This is probably because the fixed costs that would be incurred to develop a presence in Hull are high in relation to the relatively small market. This acts as a significant barrier to entry. Furthermore to attract customers away from the incumbent and overcome switching costs an entrant would have to offer substantial discounts or a differentiated (and valued) service. The anticipated revenues from such a strategy may be insufficient to cover the costs of entry.

Customer switching costs and the intensity of competition in the market

<u>UK area excluding Hull</u>

Sensitivity to price changes

6.23 Our market survey asked a sample of customers how they would respond to a 10% increase in their call bill[84]. The survey suggested that most consumers would take action in response to an increase in the price of calls:

- 26% said they would use the phone less
- 22% said they would switch home phone supplier
- 3% said they would cancel the line and use their mobile phone

6.24 22% of consumers said they would switch home phone provider which suggests that if one provider increased the price of calls they would lose a large number of customers to other providers. Furthermore, 74% of those who said they would switch home phone supplier would move both access and calls which would result in a larger revenue loss.

6.25 BT customers appear slightly more price sensitive than those of their rivals. 23% of BT customers said they would switch supplier in response to a 10% increase in call prices compared to 20% for non BT customers. BT customers also stated they would be more likely to cut back on calls (25% compared to 23% for non BT customers). Possible explanations for this finding are set out in paragraph 5.54 above.

6.26 Consumers who said they would cut back on calls in response to a price increase would consider using both mobile and email as alternatives. When asked how they would communicate instead; 46% said using mobile, 41% said they would make the communication another way (e.g. email) and 28% said they would simply cut back (respondents were allowed multiple answers). This suggests that both mobile and email are constraints on the price of fixed calls, which could limit the potential for BT to exert dominance in the fixed calls market.

6.27 The Consumer Market Research suggested that, on the whole, mobile calls were perceived to be more expensive than landline calls. The exception to this was calls to the same mobile network where landline calls were thought to be more expensive. Mobile operators are likely to impose a stronger pricing constraint for these calls.

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[83] Based on the KCOM regulated accounts which show that 4% of call origination revenues were derived from external sales (i.e. calls provided by other companies using KCOMs network infrastructure).

[84] Respondents were asked to think about what they might do if there was a permanent change in the price of their home phone calls when the price of line rental was unchanged.

6.28 There were significant differences in the perception of call costs between pay as you go and pay monthly customers. Pay monthly customers are less likely to say that mobile calls cost less than landlines for local, national, on network and off-network calls. This may be linked to the high level of inclusive cross-network minutes on some pay monthly tariffs. Thus pay monthly users are more likely to react to an increase in the price of fixed line calls that prepay or non mobile users by reducing the number (and length) of fixed line calls. The increase in the proportion of mobile users on pay monthly contracts (from 30% in 2005 to around 40% in 2008[85]) is likely to have contributed to the reduction in BT's call volumes (particularly for call to mobile). If this trend continues it is probably that BT's volumes for calls will fall further.

Hull area

6.29 As noted above, there are few alternative fixed line call suppliers in the Hull area and no alternative providers offer a combined access and calls product. This means the incentives to switch are low (e.g. most consumers want the same provider for both lines and calls).

Pricing and profitability

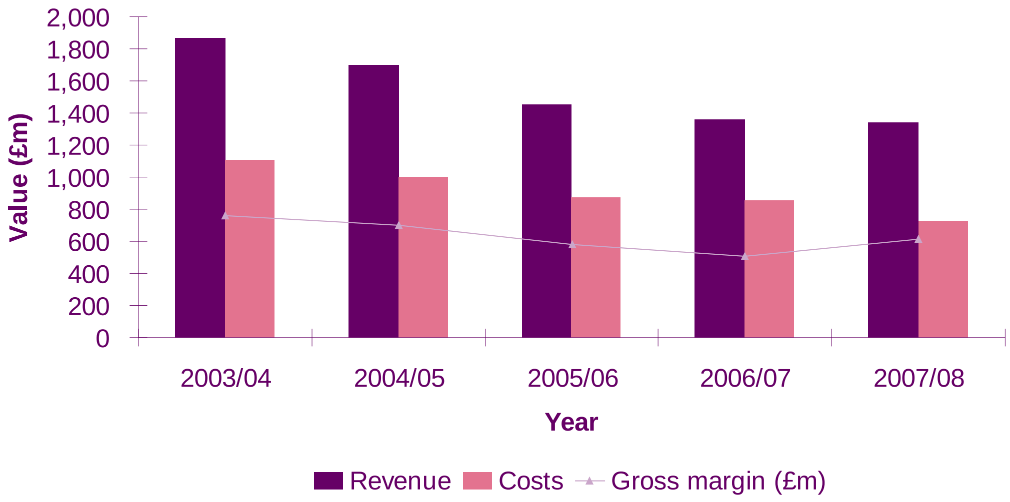
UK area excluding Hull

Profitability

6.30 The figure below shows BT's nominal revenues, costs and gross margin (the difference between revenues and costs) for the residential calls markets currently designated as SMP. Gross margin is used as a proxy for pre-tax profitability.

Figure 6.3

Total residential SMP calls market - revenues, costs and returns from 2003/04 to 2007/08



Source: BT regulatory accounts

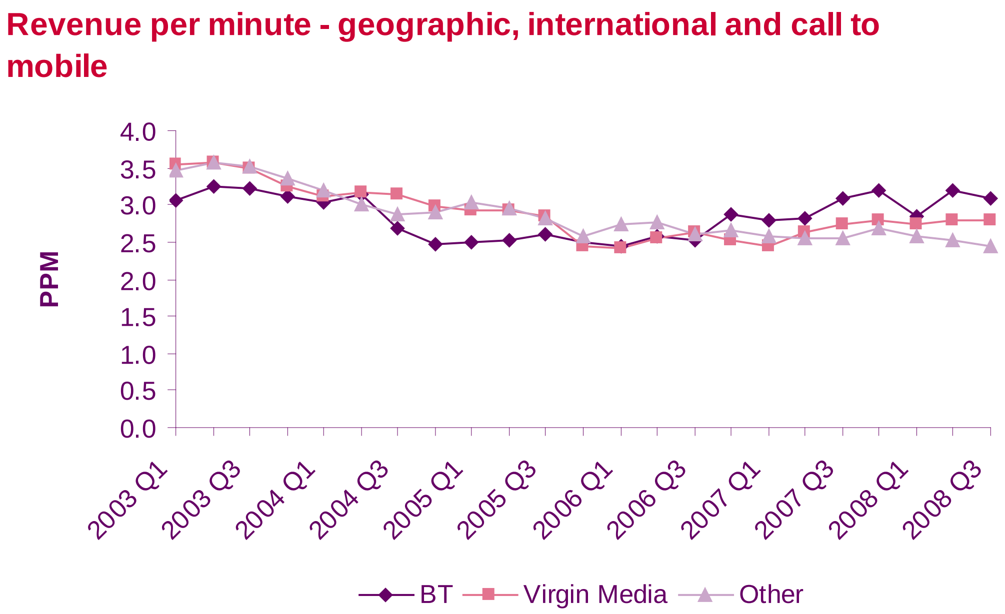
[85] Source: The Consumer Experience 2008

6.31 The figure shows that gross margin has generally fallen since the last review with the exception of 2007/8. Nominal gross margin was 20% lower in 2007/08 relative to 2003/04.

Pricing

6.32 We have calculated BT's nominal revenue per minute (RPM) across residential geographic, international and calls to mobile as a proxy for price[86]. Other calls have been excluded for the reasons set out in paragraph 6.11. Prior to 2006 BT was subject to price regulation so a comparison of RPM before this date is likely to reflect artificial regulatory constraints.

Figure 6.4



Source: Ofcom/operators

6.33 The figure shows that BT's RPM has increased since 2006, while that for other fixed providers has declined slightly. In nominal terms BT's RPM is at the same level in Q3 2008 as Q1 2003 which implies a real decline in price since the last Review. However, we do not think that the increase in RPM since 2006 necessarily reflect SMP, there are a number of other possible explanations.

Innovation in pricing strategy

6.34 In 2006 retail price controls on BT were removed meaning increased pricing freedom. Subsequently BT has changed its call prices and calling plans. This has made it difficult to analyse the cost of calls to consumers through time because a proportion of minutes are now included as part of the fixed subscription. However, our analysis has confirmed that BT's recent price changes have increased the average customer's PSTN calls and lines rental bill by less than RPI during the period (see section on BT's pricing changes since RPC were lifted below).

[86] Revenue per minute may be a better proxy for the 'actual price paid' by consumers than the headline advertised prices because it includes factors such as setup fee and rounding of call bills.

6.35 Enders Analysis[87] comment that BT's reaction to increased competition in the residential market has been to respond by cutting the price of the option 2 and 3 calls plans (now called evening and weekend and anytime plans), while offsetting this by strategically increasing the price of line rental and some out of bundle calls.

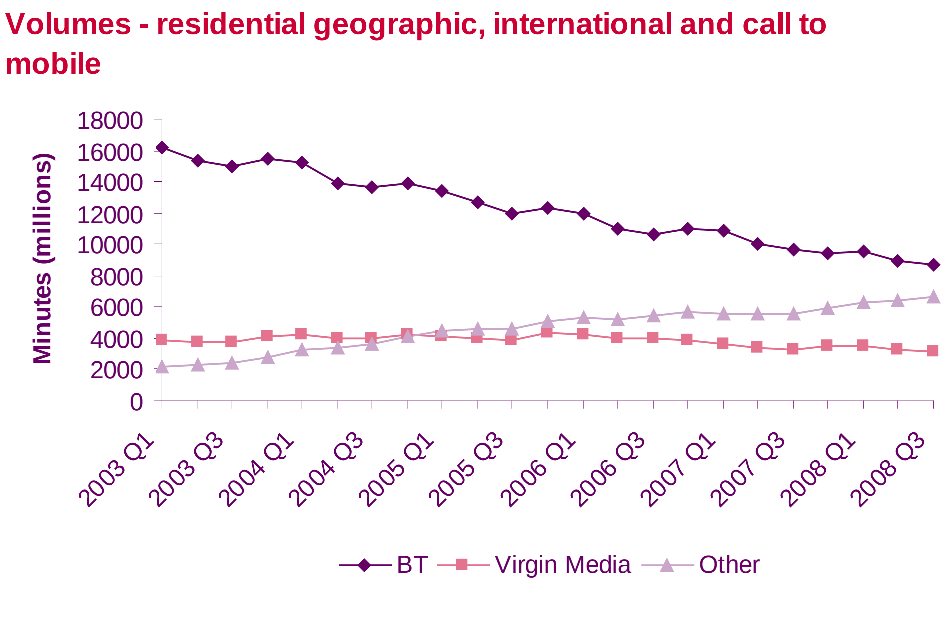
6.36 The increased price for some out of bundle calls (e.g. UK daytime calls have increased from 3ppm in 2006 to 3.91ppm in 2008 - a 30% increase) are likely to have contributed to the increase in BT's RPM.

6.37 However, against these price increases BT has sought to offer greater value in the calling plans (e.g. the evening and weekend option has decreased from £3.95 per month in August 2006 to £0 if the customer is on a 12 month renewable contract or £2.95 otherwise). Since January 2009 BT has also included 0845 and 0870 numbers within the free element of call plans.

6.38 The effect of these changes has been to encourage customers to choose the higher value packages. The number of customers on BT's 'unlimited weekend calls' package (the lowest standard call package) has decreased by around 4.3 million since August 2006 while the number of customers on the 'unlimited weekend and evening calls' and 'unlimited anytime calls' packages have increased by about 3.5 million (combined).

6.39 In addition, consumers might prefer to pay a fixed fee for a call plan because the monthly bill is less variable. In fact, some consumers might be willing to pay a premium to reduce uncertainty in their outgoings because this makes budgeting easier. Despite offering a larger number of inclusive minutes (with zero marginal cost), figure 6.5 below shows that BT's volume of minutes is falling as people substitute to mobile calls and email. This is probably one factor explaining why BT's RPM is increasing i.e. because volumes are falling faster than revenues (which are partially derived from fixed price call plans).

Figure 6.5



Source: Ofcom/operators

[87] BT retail residential telephony price changes: rebalancing Communications Act (11 February 2009), Enders Analysis.

6.40 We also note that some of the gains BT has made by changing pricing post RPC could be transitory i.e. over time people who are not utilising inclusive minutes will move to the package which offers the best value.

BT is able to charge a price premium

6.41 There are a number of reasons why BT could charge a price premium relative to its competitors. For example, BT is a strong brand and consumers might perceive that BT offers a better quality of service or is more reliable. This means BT's customers might be willing to pay a small premium relative to other providers. However, if the price premium widened sufficiently it is likely that consumers would switch provider (as suggested by BT's falling market share).

Aggressive pricing by competitors.

6.42 The lower RPM for other fixed providers might reflect a strategy to increase market share. In a market with relatively homogenous products where consumers face switching costs competitors need to offer an incentive to overcome inertia and switch from BT – who has a significant first-mover advantage because of its installed base and brand recognition. BT's competitors are likely to need to offer a discount on calls as a strategy to win customers by making their offers more attractive (for example, Sky has offered a 5% discount on UK mobile and international calls relative to BT's prices).

Other factors

6.43 There are a number of other possible explanations:

- Product mix effects - Different providers probably appeal to different types of customers. This might make it difficult to simply compare RPM across providers because their customers are likely to have a different call mix. For example, if one provider's customers tended to make more calls to mobiles (which are charged at a higher rate than geographic calls) then this would result in a higher RPM.

- Most CPs (with the exception of BT) offer customers the option of taking calls as part of a wider communications bundle, for example including broadband and/or TV. Usually the package of services is offered at a discount relative to purchasing the individual components separately. It is possible that the distribution of revenue between the components of the bundle results in other CPs reporting lower call revenues than BT. This might be the case if, say, some of the call revenues were used to "subsidise" broadband provision (it is somewhat arbitrary how the revenues arising from the sale of a bundle are allocated to the different components).

- Customers who are most price conscious (and thus tend to generate a lower RPM) might have switched away from BT in greater numbers to seek a better deal. This would leave BT with a base of customers who tend to generate a higher RPM which might help to explain why BT's RPM is higher than other providers (while at the same time suffering from significant volume losses).

6.44 There are other factors which impact on RPM but are not necessarily considered as part of the headline call price. For example, BT charges a higher call setup fee than its main rivals which might help BT to maintain a higher RPM[88] (the call set-up fee was introduced post RPC and now stands at 8p). Moreover, since the RPCs were lifted BT has moved from per second to per minute billing which increases RPM.

[88] BT's call set up fee is 8p. This compares with 7p for Sky, 6.85p for Talk Talk, and 7.82p for Virgin.

Analysis of BT's pricing changes since RPC was lifted

6.45 We have reviewed the evolution of overall call bills in the year after the price controls were lifted (August 2007 to July 2008). This might be a more appropriate metric than individual call prices or RPM because access and (at least some) calls are offered as part of a package with a fixed subscription charge. The review segmented customers by spend and looked how the overall bill (and components within it) had changed.

6.46 Across all customers the average increase in call bill due to call prices was £1.12 per month relative to the previous year. This was partially offset by savings due to package mix (e.g. moving to a package which offers more inclusive calls), line rental, discounts and option fees, meaning the overall phone bill increased by an average of £0.70 per month[89]. This is a 3.6% increase relative to the previous year, which is less that the retail price control of 4.4% (RPI +0%, based on RPI at June 2007) which would have applied had such a control been in place. This suggests that the average call bill was 0.8% lower relative to the regulatory status quo. For customers who pay by direct debit (so do not incur payment processing fees) the average overall increase in the call bill was lower at 1.5%.

6.47 A further consideration is how call bills have changed for particular groups of consumers since the RPC was lifted, for example, whether particular customer segments have incurred increased bills indicating the possibility of price discrimination. Price discrimination does not necessarily suggest SMP, but we would be concerned if there was evidence that BT is discriminating between groups of consumers if those facing price increases were to some extent 'captive' to BT i.e. unable to easily switch elsewhere.

6.48 BT offers some packages (e.g. BT basic) targeted at low income customers which are not offered by competitors. It is possible that competitors have not entered this area of the market because it is likely to be less profitable. A possible concern is that if BT increased prices for these packages, consumers might be less likely to switch to alternative options. In fact, the analysis shows that the lowest spending customers have benefited the most since RPC was lifted e.g. the average overall bill decreased by 1.5% for Light User Scheme (LUS) customers and decreased by 0.2% for the lowest spending consumers[90].

6.49 Lifting the RPC has given BT extra flexibility to innovate and optimise the pricing strategy across products. Individual price increases for particular call types does not necessarily suggest SMP because we need to consider the wider package and overall cost to consumers. The evidence suggests that BT's customers are choosing to migrate to higher value call packages because they are perceived to be good value. The analysis of BT's pricing behaviour since the RPC was lifted does not seem consistent with BT having SMP.

Hull area

Profitability

6.50 Information on returns for call origination and termination at the wholesale level is only available for residential and business markets combined. The return from call origination fell by 25% in the last year from £1,139,000 in 2007 to £858,000 in 2008. The return at the retail level on call termination declined by 23% – from 938,000 in 2007 to 727,000 in

[89] This assumes constant call volumes and includes payment processing fees.
[90] The lowest spending consumers refers to the bottom 3 deciles by spend.

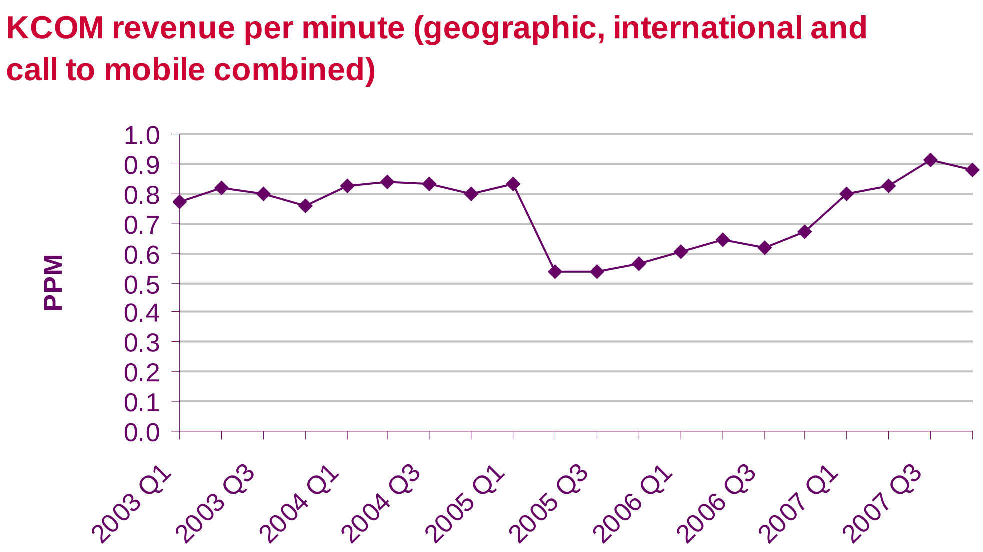
2008[91]. The return on mean capital employed remained constant at 13% for both origination and termination.

6.51 Wholesale remedies are also in place in Hull so if KCOM did make excess profits, it is likely that at least some CPs might express an interest in serving retail customers in Hull by taking advantage of these remedies. This threat of entry is also a relevant factor in preventing KCOM from exploiting its retail customers.

Pricing

6.52 We have calculated KCOM's nominal revenue per minute (RPM) across geographic, international and calls to mobile as a proxy for price[92].

Figure 6.6



Source: KCOM S135 return

6.53 The figure shows that KCOM's RPM decreased in 2005 which appears to have been driven by a sudden decrease in call revenue. Since 2005 RPM has increased, but at the end of 2007 was only slightly higher in nominal terms compared to 2003. As noted in the access section above KCOMs call package prices are broadly comparable to BT.

Forward look

6.54 Both BT and KCOM have lost call volumes due to mobile and email substitution. This trend is likely to continue as broadband penetration increases and the proportion of mobile users with pay monthly contracts (which have inclusive minutes) rises. The number of adults using VOIP has increased from 6% in 2006 to 10% in 2008[93] and we anticipate that volumes of VOIP calls will continue to grow which could impose a further competitive pressure on the narrowband calls market.

[91] Source: KCOM's Regulatory Financial Statements year ended 31 March 2008.
[92] Revenue per minute may be a better proxy for the 'actual price paid' by consumers than the headline advertised prices because it includes factors such as setup fee and rounding of call bills.
[93] The Consumer Experience 2008 p20.

6.55 BT's share of call volumes has fallen by 24% since the last review. We anticipate that this trend will continue as other fixed providers expand market share e.g. as Sky cross sells talk products to its existing customer base.

6.56 The prospect of entry in Hull appears muted thus we anticipate that KCOM will continue to have a high market share for fixed minutes.

Conclusions on residential calls markets

UK area excluding Hull

6.57 We consider that BT does not have SMP in the fixed calls market for the following reasons:

- The wholesale remedies have led to the development of products which enable competitors to replicate the services offered by BT without making significant infrastructure investments. This has lowered barriers to entry and growth.

- New firms have entered and expanded in the market resulting in a fall in BT's market share.

- Some of the main competitors such as Sky are going to increasingly rely on LLU during the review period to further reduce their costs and increase the competitive pressure on BT.

- Consumers are willing and able to switch provider (evidenced by the fall in BT's market share).

- Since RPC were lifted the overall average increase in the phone bill has been below inflation – this does not suggest BT is pricing excessively.

- The overall cost of a fixed line access and calls package is comparable to similar OECD countries.

Question 6.1 Do you agree with the analysis set out above for the residential calls market in the UK excluding the Hull area which found that BT does not have SMP? If not, please provide reasons.

Hull area

6.58 We consider that KCOM does have SMP in the fixed calls market for the following reasons:

- There are no significant competitors in the market.

- Threat of entry is somewhat muted.

6.59 With respect to the three tests for *ex ante* competition in relation to the Hull area, we are of the view that the market does not tend toward competition due to the presence of barriers to entry and a lack of competition in the market. Therefore the Commission's first two tests are not satisfied.

6.60 In addition, we do not think that competition law alone is enough to address the SMP in this market as the entry barriers are too high and have proved to be effective in excluding competition. Therefore it is appropriate to impose *ex ante* regulation on the market.

Question 6.2 Do you agree with the analysis set out above for the residential calls market in the Hull area which found that KCOM continues to have SMP? If not, please provide reasons.

Business market for calls

Market shares

UK area excluding Hull

6.61 Table 6.7 shows BT's market share of minutes and revenues for geographic, international and call to mobile (other calls are excluded for the reason set out in paragraph 6.11, market shares for all calls are included in annex 6). The table shows that BT's share of minutes has fallen since the last review – from 42% in 2003 to 37% in 2008. BT's share of revenues has fallen by a similar amount from 50% to 44%.

Figure 6.7 Market shares for business calls - geographic, international and call to mobile

	Volumes			Revenues		
	BT	Virgin	Other fixed[94]	BT	Virgin	Other fixed
2003	42%	7%	51%	50%	7%	43%
2004	41%	7%	53%	48%	7%	46%
2005	40%	7%	54%	45%	6%	48%
2006	38%	6%	56%	46%	6%	49%
2007	38%	6%	56%	46%	5%	49%
2008 Q1	38%	6%	56%	46%	5%	49%
2008 Q2	38%	6%	56%	46%	5%	49%
2008 Q3	37%	6%	57%	44%	5%	51%

Source: Ofcom/operators

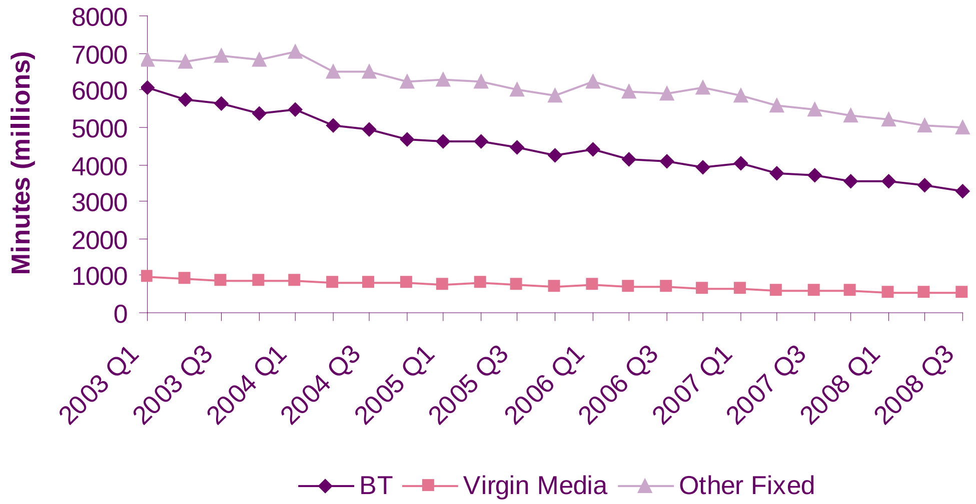
6.62 BT's share of revenues is higher than their share of minutes which might suggest that BT is charging higher prices than its competitors. One possible explanation is that BT is able to charge a premium for some services. An example might be where a small number of access lines and calls are provided as part of contingency arrangements for some businesses (particularly because BT might be perceived as more reliable). Because the overall expenditure on these lines/calls is likely to be small in relation to total spend business are less likely to seek alternatives.

6.63 The figure below shows the volumes of minutes for geographic, international and call to mobile through time. Since 2003 BT's business minutes have fallen by around 40%. However, this has not been reflected by an increase in minutes for other providers, which suggest that businesses have substituted away from fixed narrowband calls to other communications products e.g. email, mobile and VoB. It is not possible to disaggregate the impact of each individual product on minutes. However, the loss of minutes to other products will have increased the competitive constraints on BT (and others) e.g. there may be pressure to reduce prices to stem the loss of volumes to other sources.

[94] Other fixed includes direct and indirect access.

Figure 6.8

Volumes - business geographic, international and call to mobile



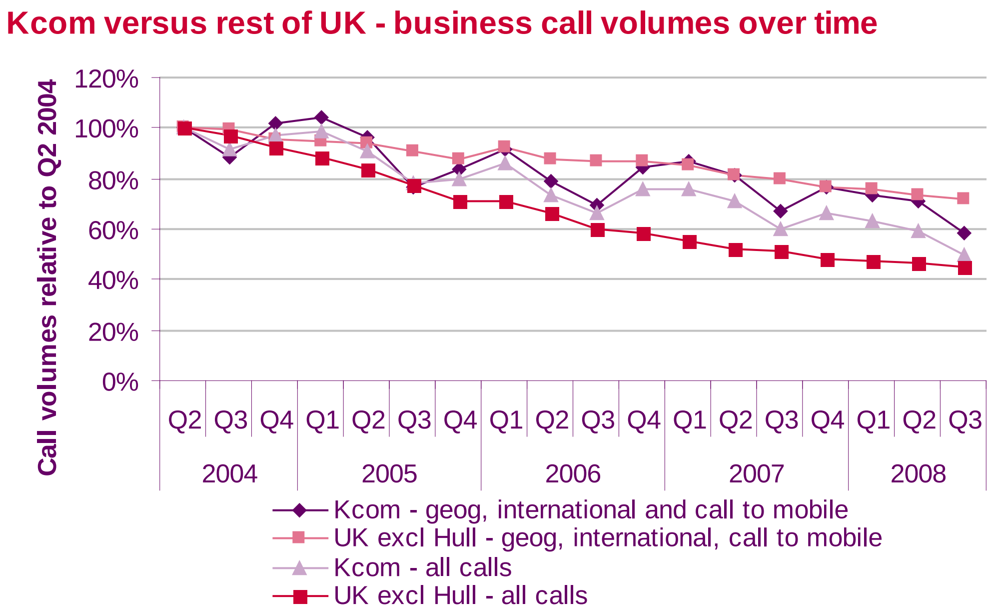
Source: Ofcom/operators

<u>Hull area</u>

6.64 The figure below shows how call volumes for KCOM and all UK fixed providers have changed over time relative to a base year (Q2 2004). The figure provides information separately for 1) geographic, international and calls to mobile and 2) all calls (which includes 1) and all other calls). We would expect the 'all calls' volumes to have declined more steeply due to broadband takeup leading to a reduction in the volume of dial up internet calls.

6.65 The volume of geographic, international and call to mobile has declined over time which reflects substitution to other means of communication e.g. VoB, mobile and email. The decline in KCOM's volumes is broadly similar to the UK as a whole which suggests substitution from fixed calls to other communication products is similar in Hull and across the rest of the UK.

Figure 6.9



Source: KCOM/operators/Ofcom

6.66 VoB is likely to be more prevalent in the business market and it is possible that part of the decline in call minutes is due to substitution to VoB offered by alternative providers. Based on the available data it is not possible to strip out the impact of VoB from other factors e.g. substitution to email and mobile. Overall we do not consider that VoB provides a sufficient constraint to counteract the KCOM's high market share in narrowband calls.

6.67 A few competing operators offer fixed calls to business customers via IA and alternative means e.g. leased lines. However, we believe these competitors account for a small part of the market. KCOM's Regulatory Financial Statements (year ending 31 March 2008) report less than 5% of call origination revenues[95] derived from external sales e.g. IA. Information provided by KCOM on average monthly minutes from February 2008 to January 2009 shows that indirect access minutes[31] are 10% of total outbound minutes.

6.68 The high market share of KCOM creates a presumption of significant market power.

Barriers to entry and expansion

UK market excluding Hull

6.69 As noted above, we have seen an increase in the uptake of wholesale products since the last review. In addition, a number of operators provide services to larger businesses over their own (i.e. non BT) infrastructure. The uptake of wholesale calls products is reflected in the decrease in BT's retail share of fixed call minutes. Overall this suggests that barriers to entry have reduced since the last Review.

[95] This includes residential and business customers.

Hull area

6.70 Uptake of wholesale products is negligible in the Hull Area. There are no WLR providers for business exchange lines, and revenues from IA account for less than 5% of total call origination. As noted for residential calls in the Hull area, this is probably because the fixed costs that would be incurred to develop a presence in Hull are high in relation to the relatively small market which acts as a barrier to entry.

Customer switching costs and the intensity of competition in the market

UK area excluding Hull

6.71 In our market research sample 17% of SMEs currently used a CPS provider (with BT for line rental). The fall in BT's market share suggests that SME are actively switching to other providers (with many switching both line and calls).

6.72 As noted in the access section, SMEs generally seem to have a greater degree of awareness regarding alternative suppliers and switching options than residential customers.

Hull area

6.73 As noted above, there are only a few alternative suppliers in the Hull area thus there is little scope for switching. The number of business analogue exchange lines provided by KCOM declined slowly over recent years (a decrease of 3% between 2005/6 and 2007/8) which suggests actual switching to alternative providers is limited[96].

Pricing and profitability

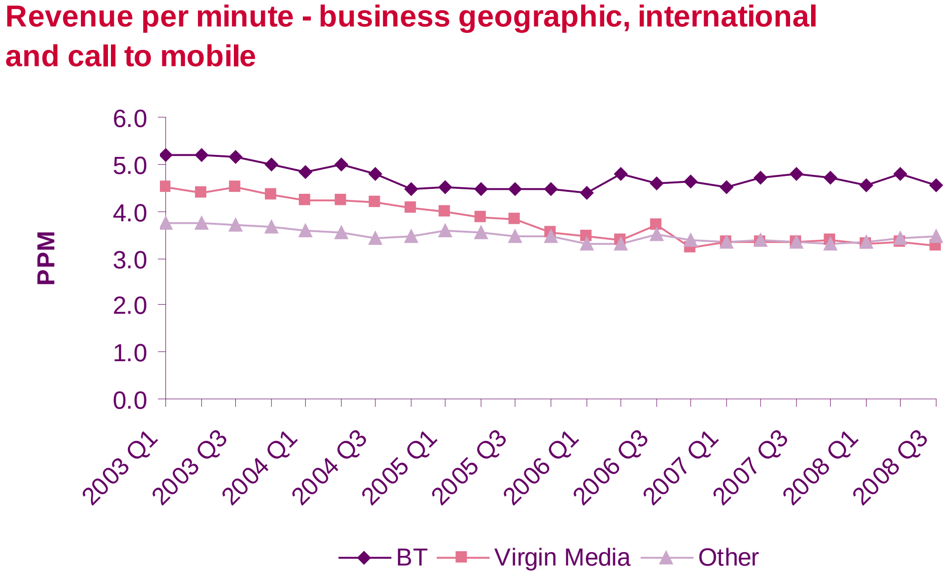
UK area excluding Hull

Pricing

6.74 We have calculated BT's nominal revenue per minute (RPM) across business geographic, international and call to mobile as a proxy for price[97]. Other calls are excluded for the reason set out in paragraph 6.11.

[96] Assuming the overall market size is relatively constant.
[97] Revenue per minute may be a better proxy for the 'actual price paid' by consumers then the headline advertised prices because it includes factors such as setup fee and rounding of call bills.

Figure 6.10



Source: Ofcom/operators

6.75 The figure shows that BT's RPM remained fairly stable since the last Review, and other fixed providers show a similar pattern. BT's nominal RPM is 12% lower in Q3 2008 relative to Q1 2003.

6.76 Although RPM is little changed since the last Review, BT's RPM is at a higher level than other fixed providers. As discussed when considering the residential market, there are a number of reasons enabling BT to charge a price premium relative to competitors. For example, BT is a strong brand and consumers might perceive that BT offers a more reliable service and thus be willing to pay a small premium relative to other providers. Some organisations tend to keep a few BT lines for contingency purposes but move most of their data/calls traffic with an alternative provider. BT might be able to charge a premium for the perceived reliability of its service but actually earns limited revenues from these organisations.

6.77 Other fixed providers may charge a lower price for calls (and hence have a lower RPM) as a strategy to increase market share. This is consistent with the information on market share (above) which shows that BT market share of minutes has declined since 2003 while the share for other fixed providers has increased. In addition, Virgin and other fixed providers might target larger businesses where they are able to give a larger discount on call prices (thus have a lower RPM).

6.78 Another possibility is that the business customers who are most price conscious (and thus tend to generate a lower RPM) have switched away from BT in greater numbers to seek a better deal. This would leave BT with a base of customers who tend to generate a higher RPM which might help to explain why BT's RPM is higher than other providers.

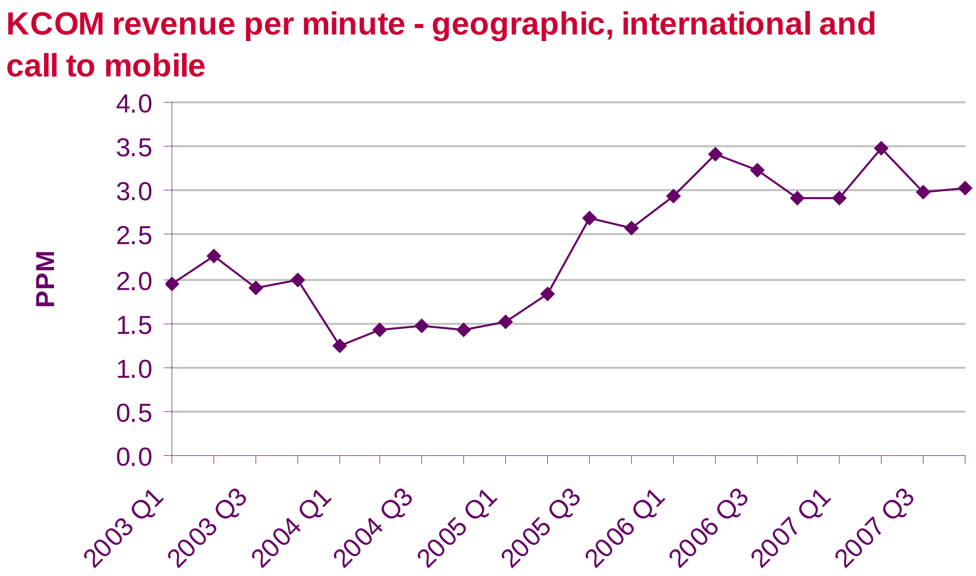
6.79 There are other factors which might have an impact on revenue per minute. For example, BT has moved from per second to per minute billing and increased set up charges. These changes do not impact on the variable pence per minute price but impact on the overall call bill and thus call revenues. It is difficult to disentangle the impact of these various changes.

Hull area

Pricing

6.80 The figure below shows KCOM's revenue per minute in nominal terms for geographic, international and call to mobile combined. RPM has generally increased since 2005, but remains lower than BT's. BT's RPM for geographic, international and call to mobile was 4.7p in Q4 2007 compared with 3.0p for KCOM.

Figure 6.11



Source: KCOM S135 information. Note: operator assisted calls and 'other' call types are excluded.

Forward look

6.81 Both BT and KCOM have lost call volumes due to VoB, mobile and email substitution. This trend is likely to continue particularly as businesses move to VOIP solutions for calls. We have observed that competition from VOIP is developing more quickly in the business market compared to the residential market.

6.82 BT is also likely to lose call volumes and market share as other fixed providers expand (in line with recent trend).

6.83 The prospect of entry in Hull appears muted thus we anticipate that KCOM will continue to have a high market share for fixed minutes.

Conclusions on business calls markets

UK area excluding Hull

6.84 We consider that BT does not have SMP in the fixed calls market for the following reasons:

- The wholesale remedies have led to the development of products which enable competitors to replicate the services offered by BT without making significant infrastructure investments. This has lowered barriers to entry and growth.

- New firms have entered and expanded in the market resulting in a fall in BT's market share.

- A number of firms offer services using their own infrastructure which suggests entry barriers are lower than in the residential market.

- Relaxation of the SMP regulations in 2007 for large businesses appears to have been successful.

- Recent market research has shown that businesses are aware of alternative providers and appear willing to switch.

Question 6.3 Do you agree with the analysis set out above for the business calls market in the UK excluding the Hull area which found that BT does not have SMP? If not, please provide reasons.

Hull area

6.85 We consider that KCOM does have SMP in the fixed calls market for same reasons set out for the residential calls market (refer to 6.58 to 6.60 above).

Question 6.4 Do you agree with the analysis set out above for the business calls market in the Hull area which found that KCOM continues to have SMP? If not, please provide reasons..

Section 7

Impact Assessment and Market Remedies

Introduction

7.1 The analysis presented in this section represents an impact assessment, as defined in section 7 of the Communications Act.

7.2 Stakeholders should send any comments on this impact assessment to us by the closing date of this consultation.

7.3 Impact assessments provide a valuable way of assessing different options for regulation and showing why the preferred option was chosen. They form part of best practice policy-making. This is reflected in section 7 of the Communications Act, which requires that generally we have to carry out impact assessments where our proposals would be likely to have a significant effect on businesses or the general public, or where there is a major change in Ofcom's activities. However, as a matter of policy Ofcom is committed to carrying out and publishing impact assessments in relation to the great majority of our policy decisions. For further information about our approach to impact assessments, see the guidelines, Better policy-making: Ofcom's approach to impact assessment, which are on our website http://www.ofcom.org.uk/consult/policy_making/guidelines.pdf

Summary

7.4 In this section we consider the likely outcome of the deregulatory findings set out in this review and, where markets are still considered to have an SMP operator, we consider the appropriate response to the findings of SMP.

7.5 As we will discuss, we consider that the impact of deregulation should be beneficial for both citizens and consumers, allowing BT to operate more freely in the retail market with the expected outcome from the greater competition of enhanced and/or cheaper services for consumers and increased incentives on competitors to innovate.

7.6 With respect to the remaining markets with an SMP operator, we consider that our approach to these two incumbents should be quite different.

7.7 In the case of BT's SMP in the ISDN markets, we consider that the existing remedies may in effect be counterproductive as the conditions within these, largely static, markets are conducive to price following. We are concerned that the price publication and non-discrimination requirements would likely dull the incentive for BT to compete strongly as any price cuts only ensure that the total revenue in the market would reduce without delivering BT any competitive advantage or attracting new customers into the market.

7.8 The challenge with respect to KCOM is very different. We have yet to see effective entry by competitors in the retail markets in Hull (this is addressed in the Wholesale Narrowband Market Review). While it is difficult to fully determine, the deduction in access lines and calls volumes in Hull suggests that there has been some reaction by Hull residents who have sought second best alternatives to fixed line narrowband. However, as discussed in earlier sections, these alternatives are not sufficiently close substitutes to be considered in the same market and, hence, we still need to maintain retail remedies that would attract competitor entry while seeking to ensure that Hull residents are not unduly disadvantaged compared to residents in the rest of the UK. We consider this issue will become increasingly pressing now that BT is in a position to bundle narrowband with other telecommunications services.

7.9 In considering our proposals, we have met with Consumer Focus and made use of the Consumer Interest Toolkit to ensure that all relevant issues are addressed.

Expected outcomes of deregulation of BT

7.10 As discussed in earlier sections, we consider that the state of competition in the market is such that BT no longer holds significant market power. As a consequence we are required to remove the existing remedies on BT.

7.11 We consider that the main impact of lifting current remedies will be to allow BT to offer bundled packages to consumers and bespoke prices to business. This will enable BT to compete more fiercely with rival providers. This, in turn, should encourage greater competition by Communications Providers with the expected outcome of lower prices for consumers and businesses and incentives for more innovation and service differentiation.

Who will benefit?

7.12 We believe that these changes will benefit the whole community, both directly through lower telecommunications bills and indirectly through lower business costs and improved service to consumers and businesses.

7.13 Increasingly access to broadband is seen as a core services. Thus access to attractively priced bundles is not a benefit solely directed households with higher incomes. Particular groups of low income households place a particularly high value on bundles which include low cost broadband eg households with teenage children[98]. This is because the internet is seen as a necessity for education and, to a lesser extent, entertainment, regardless of a family's income level. Other groups that demand bundled services include those that are homebound due to disability or ill health. These individuals are more likely to heavily rely on a range of services provided by telecommunications systems. So, improved competition in the supply of bundled services will provide a direct benefit to more vulnerable social and economic groups.

7.14 Improved service to business, which is perhaps even more important in the current economic climate, is also expected. Removal of regulatory barriers between narrowband and other telecommunications services will allow BT to expand the range of packages on offer and to improve pricing.

Implication for retail regulation

7.15 As discussed above, the removal of SMP related regulation does not mean that BT's retail operation is unregulated. BT is and will remain bound by the by General Conditions and Universal Service Conditions, in addition to non-sector specific consumer protection legislation which cover all operators.

7.16 For example, as noted earlier in section 5, in response to the recent 12 month rolling contract proposal by BT, Ofcom has set out some general guidelines on contract terms which apply to all Communications Providers based in the Unfair Terms in Contracts Regulations ("UTCCR").

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[98] Ofcom Consumer Experience Report 2007

7.17 BT is also still the designated Universal Service provider in the UK outside of Hull (where it is KCOM), which ensures a national charge for basic telephony services and the provision of services for disadvantaged groups (such as the Low User Scheme (or soon to be BT Basic) and support for hearing impaired consumers). Providing society continues to require such outcomes then BT (or another designated organisation) will provide these services.

7.18 We will shortly be undertaking a review of the current USO implementation. We intend to review the existing implementation of the USO and consider whether changes to it are required. It will include an assessment of the extent to which the USO results in a significant net burden upon BT and KCOM, the current universal service providers, and will consider the case for alternative funding and procurement models to ensure that USO provision is both effective and proportionate. This will be the most significant review we have carried out since 1997. It will also be necessary to consider, in this context, any changes to the USO that arise from the Government's Digital Britain review and how issues such as its proposed Broadband Universal Service Commitment might impact the scope or implementation of the Universal Service Order.

Market share and inactive customers

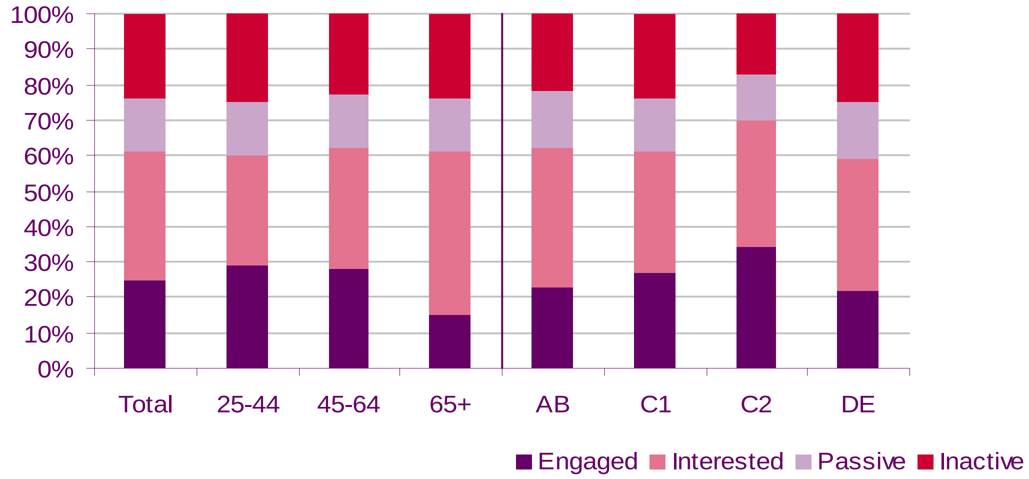
7.19 One clear characteristic of this market is a relatively high percentage of inactive customers in terms of fixed line telephone market participation . This is to be expected as the default position for customers not making a choice is almost always to remain with BT. As discussed in Section 4, we do not consider that the continuing relatively high market share of BT is itself an indicator of competition failure. As the incumbent, BT will, for the foreseeable future, retain a relatively high market share.

7.20 We would be concerned if BT were able to exploit the existence of this group, say through targeted packages which advantaged consumers who were more likely to be market active.

7.21 Our analysis suggests that this would be difficult for BT. According to Ofcom's Consumer Experience (2008) report, this inactivity is spread fairly evenly across age and socio-economic groups (see figure 7.1).

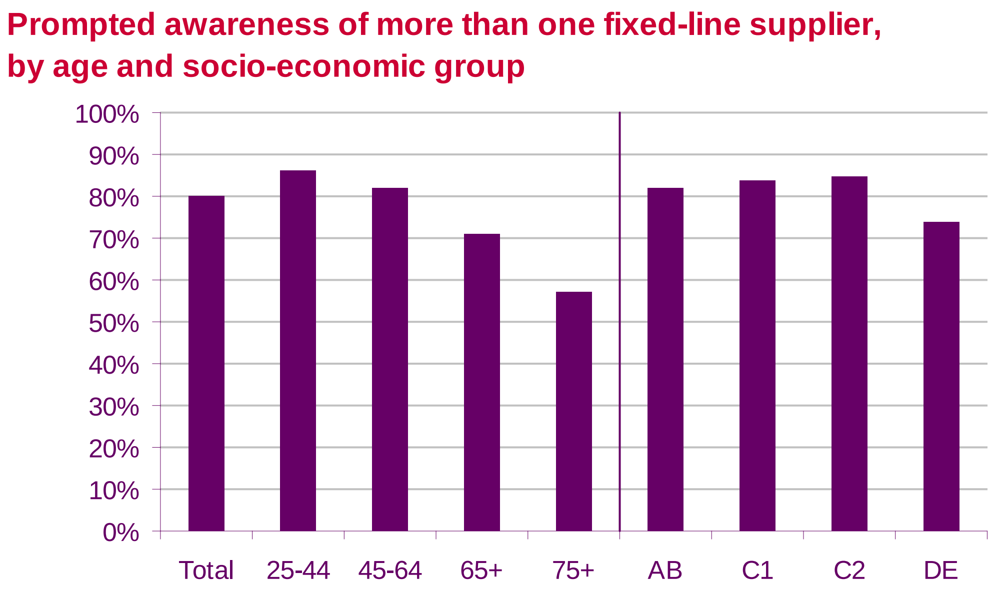
Figure 7.1

Demographic differences between participation segements in the fixed-line market



7.22 Inactivity does not seem to be simply a factor or awareness of competition. As figure 7.2 shows, levels of awareness are higher than levels of activity. This suggests that a significant proportion is inactive through choice.

Figure 7.2



7.23 The absence of a clearly defined social grouping for lack of activity suggests that BT would have difficulty targeting such groups. Equally, the fact that for at least some of the customers this lack of activity is a factor of choice suggests that, if prices increased activity might also increase.

7.24 We are already seeing the growth of retail providers who are specifically targeting narrowband customers on price alone and who have a wide and effective distribution/marketing presence (for example the Post Office). The availability of attractive alternative products means BT would be less likely to find a discriminatory strategy profitable (because customers could easily switch away to other providers).

7.25 The above notwithstanding, we consider that it is important to avoid changes to regulations that would allow greater customer segmentation to the detriment of inactive customers. For example, we may need to be careful about any proposals that would allow BT to target discounts to customers indicating an intention to leave.[99]

Question 7.1 Do you agree with our assessment of the likely impacts of deregulations? What, if any, changes to our current procedures/approach do you consider we should adopt in the light of the deregulation?

Remedies for BT's SMP in ISDN2 and ISDN30

7.26 BT retains SMP in the two ISDN access markets. For the purposes of this section we will treat ISDN2 and ISDN30 together. While these are clearly separate markets, with some

[99] For example 'losing provider led' migration is the process by which the customer must contact the provider to notify them of his/her intention to move. In order to complete this move, as is the case for broadband, the customer must seek a Migration Authority Code (MAC). For those customers requesting a MAC, BT could identify those with an intention to switch and offer them bespoke rates.

variation in the market conditions and BT's relative market power, the key characteristics are very similar.

7.27 The characteristics of the ISDN markets are ones of fixed costs, slowly increasing standard prices (as well as widely used bespoke pricing by BT's competitors), increasing returns and constant market size for BT.

7.28 Charts 5.25 and 5.30 in section 5 display standard pricing information gathered from other operators – two pricing structures are displayed as a comparison to BT. A number of ISDN operators also offer bespoke pricing.

7.29 While the market is difficult to analysis given the dominance of BT, the evidence suggests that pricing are largely set in relation to the BT price.

7.30 BT is currently subject to two SMP remedies:

- No undue discrimination; and
- Price publication.

7.31 These remedies restrict BT from offering bespoke pricing to a customer without being forced to offer it to all customers and also ensure that all its packages are visible to competitors and customers.

7.32 The general objectives of these remedies are to allow competitors to enter the market with confidence in the charges the incumbent sets and to avoid the incumbent selectively undercutting new entrants.

7.33 While these objectives are appropriate in principle, our assessment is that the current retail remedies are not effective in achieving the optimal competitive level. This is because there is insufficient incentive for firms to compete given the risk price reductions will reduce margins from existing customers. This is true for both BT and other Communications Providers. For BT price publication ensures that any price change flows through across the market. For a Communications Provider the impact is more indirect because if one was to enter the market aggressively with a large scale campaign, BT, at some point, would be likely to react and thus, given price publication and non-discrimination, all prices in the market would reduce – without any compensating increase in demand.

7.34 This disincentive to competition has led to a situation in the markets for ISDN2 and ISDN30 where BT has been able to increase prices in the last two years (though they has been some loss of market share).

7.35 We have two real alternatives to the current approach. Either:

- Option 1 – to impose price controls on BT to reduce prices closer to a competitive level; or
- Option 2 – remove existing retail remedies, relying on wholesale remedies to control the cost of market entry.

Option 1 Price controls

7.36 As set out below, we consider that the imposition of price controls would, in the medium term, be disadvantageous to customers and consumers.

7.37 The ISDN market services, both ISDN2 and ISDN30 are potentially addressable by alternative, IP systems. Such systems have inherent advantages in long term operating costs and increased flexibility, but such advantages have to be measured against the initial cost of investment. At present, customers appear to be remaining with ISDN systems while legacy equipment is still operational.

7.38 We would be concerned that price controls would act as a further deterrent to the investment of Communications Providers by artificially sustaining the ISDN technology.

Option 2 Reliance on wholesale remedies

7.39 The alternative option – reliance solely on wholesale remedies – would offer the advantage of allowing BT to selectively compete without each offer potentially impacting onto contracts with existing customers. This would introduce a greater degree of uncertainty into the tender process for other Communications Providers of ISDN services. Given the maturity of the market and the confidence Communications Providers would have in their understanding of BT wholesale costs, we consider that this would largely act to encourage lower costs and discourage price following.

7.40 There is clearly a risk of adverse price discrimination in this Option. However, given the wholesale regulations, end customers are able to evaluate the offers against available information on underlying costs.

7.41 As set out in Section 2 and Annex 7, we can rely on wholesale remedies for retail SMP. Article 17 of the Universal Service Directive restricts the imposition of regulatory controls on retail services to situations where obligations that could be imposed under the Access Directive or Framework Directive would not, in themselves, be sufficient to achieve the objectives set out under article 8 of the Framework Directive. This restriction is repeated in section 91 of the Communications Act. In finding a retail market not to be effectively competitive, Ofcom must therefore consider the effectiveness of access-related conditions and SMP condition imposed under sections 87 to 90 in related wholesale markets, when determining what remedies, if any, are appropriate at retail level.

7.42 The wholesale remedies for the ISDN2 and ISDN30 markets are being reviewed in the Fixed Narrowband Wholesale Services Market Review. The recommendations of that review to be imposed upon BT for both ISDN2 and ISDN30 markets are:

- The requirement to provide network access on reasonable request – this removes the requirement of a competing Communications Provider to invest in building its own infrastructure, reducing the barrier to market entry.

- Request for new network access – an improved Statement of Requirements (SOR) process reduces BTs incentive to delay new network requests by establishing clearly defined timescales for each stage of the process.

- Requirement not to unduly discriminate – ensures that the dominant firm cannot tailor the terms of conditions of wholesale service provision in an inequitable way.

- Requirement to publish a reference offer – this assists Ofcom with transparency in monitoring for potential anti-competitive behaviour and, coupled with the requirement not to unduly discriminate, gives confidence to those purchasing wholesale services that they are being provided on non-discriminatory terms.

- Requirement to notify charges, terms and conditions – the dominant firm is required to announce changes to charges in advance of doing so, which encourages stability in the market and gives competing Communications Providers time to consider whether such changes require amendments to their own retail offerings.

- Requirement to notify technical information – the dominant firm must do this 90 days in advance of providing new wholesale services or amending existing technical terms and conditions, reducing competing Communications Providers barrier to market entry.

- Cost accounting and cost orientation[100] - charges must be on the basis of Long Run Incremental Costs (LRIC) plus an appropriate mark up for common costs (across products) and for recovery of the cost of capital, which promotes efficiency and effective downstream competition.

- Accounting separation – requires the dominant firm to account separately for internal and external sales, allowing Ofcom and competing Communications Providers to monitor its activities and ensure that the dominant firm doesn't discriminate in favour of its own downstream business.

- Transparency as to quality of service – requires the dominant firm to publish data regarding delivery of wholesale services which ensures that it cannot favour its own downstream business over competing Communications Providers by differentiating on price terms and conditions.

7.43 We consider that these proposed remedies will enhance the level of competition in the ISDN2 and ISDN30 markets through the encouragement of Communications Providers to compete directly with BT via low capital risk wholesale products.

7.44 In addition, maintaining the SMP finding ISDN2 and ISDN30 markets allows Ofcom to keep flexibility in the use of ex post competition powers, should concerns emerge.

7.45 Accordingly, we are proposing to remove retail remedies for the ISDN markets.

Question 7.2 Do you agree with our assessment of the characteristics of the ISDN2 and ISDN30 markets? Subject to your assessment of the markets, do you agree with the proposed removal of retail remedies for ISDN2 and ISDN30 and reliance on wholesale remedies alone?

Remedies for KCOM SMP markets

7.46 KCOM's SMP operations in Hull are all subject to two SMP remedies:

- No undue discrimination; and

- Price publication.

7.47 As we have observed, while these remedies have not led to a significant entry of retail competitors, there has been some market entry and there is, at present, interest from at least one Communication Provider in a wholesale access product.

[100] In the Fixed Wholesale Services Market Review, Ofcom is still considering whether cost orientation is an appropriate remedy for the ISDN30 market, or if a more direct remedy such as a price control is required. It has asked Stakeholders for their views on the matter.

7.48 We discuss the encouragement of competitor entry through wholesale products in more detail in the Wholesale Narrowband Services Market Review. Our choice here is:

- Option 1 – Remove existing remedies and rely on wholesale remedies;
- Option 2 – Maintain the existing remedies; or
- Option 3 – Introduce more direct intervention on pricing.

Option 1 Remove existing remedies

7.49 Given the lack of competitive entry the case for reliance on wholesale remedies alone seems week. Wholesale remedies have clearly, so far, not enabled or encouraged sufficient competitive entry. Accordingly we consider that the protection against abuse of its SMP position provided by the price publication and non-discrimination remedies (which ensure that KCOM's actions are transparent) remains essential.

Option 2 vs Option 3

7.50 The argument for price controls principally rests on a consideration of whether the Hull markets are ever likely to see new competitor entry. Price controls, assuming that the price allowed is below what KCOM would intend to charge to its own devices, will necessarily increase the barrier to entry.

7.51 At present, KCOM charges are not noticeably out of alignment with national charges. This is possibly due to the potential threat of price controls, the risk of encouraging market entry by exposing supernormal profits and the reaction of its customer base/shareholders (an overlapping group). There is no reason to expect this to change (except with respect to bundles of products which we discuss separately below). Equally, it is not clear that price controls would lead to controls substantially below that which is currently being charged.

7.52 Given the lack of clear benefit from increased intervention, the costs of such an intervention and the continuing prospect of new market entry, price controls would not appear justified at this time. We consider that it is appropriate to continue with the existing remedies for all markets.

Question 7.3 Do you agree with our continued imposition of retail price publication and no undue discrimination remedies on KCOM in Hull? If not, please state your reasons and your suggestion of the appropriate response to the SMP findings?

Potential future concern in Hull

7.53 There is, however, a potential complication with the retention of current remedies. With the deregulation of BT we would expect there to be an increasing market drift in the UK towards bundles of narrowband and other services, with pricing below the sum of the component service charges.

7.54 This is already the case for many Communications Providers but we can foresee the situation where the only consumers/business customers unable to benefit from such an arrangement would be Hull residents, unless new market entrants were to provide this.

7.55 This remains, at present, a hypothetical situation, but we consider it is appropriate to consider the options for our response in this consultation to inform our approach should this arise. For clarity, we are not recommending a remedy or solution at this time.

7.56 We think that the appropriate options would be:

- Option 1 – Allow the situation to emerge and forbid KCOM from bundling, thus encouraging entry by bundlers (including now BT);
- Option 2 – Allow KCOM to offer a bundled product without specific further conditions;
- Option 3 – Allow KCOM to offer a bundled product but require referral of that product to Ofcom for consideration – with the aim of minimising the increase in barriers to entry.

7.57 Ultimately, any approach would have to address the need to satisfy general duties of furthering the interests of consumers and citizens, having regard to choice, price and value for money for customers.

7.58 This should be achievable if we can evidence the argument to the effect that there is no current need for explicit bundle regulation in Hull, but we are mindful of the issue. However the appropriate action on our part is one of keeping the area under review.

7.59 The first question to ask is, to what extent do the current conditions prohibit bundling. While this is not explicit in the regulations, as noted in earlier reviews (most recently the Replicability Statement (see Section 3)) Ofcom's current stated interpretation of the no undue discrimination SMP services condition, is that Ofcom assumes that bundles of SMP and non-SMP products would be likely to be unduly discriminatory. Were we to allow KCOM to offer bundles without further regulations, we would need to re-examine this interpretation.

7.60 ERG common position on remedies is that specific requirements that can be imposed under A17(2) USD to not unreasonably bundle services. This would be beyond the current conditions (it seems as though the non discrimination is being taken (currently by BT and KCOM) as a restriction on bundling). The Common position then goes on to suggest that where such a restriction could rule out "welfare enhancing bundles", an alternate 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.[101]

7.61 Clearly, as discussed by the ERG, NRAs should take into account the danger of prohibiting bundles which may increase welfare and that a blanket prohibition of bundles may rule out welfare enhancing bundles, balancing that against the welfare gains in preventing dominant undertakings from distorting competition in horizontally related markets. This consideration is also consistent with S4 of the USD which considers the need to balance promotion of competition and promotion of citizens interests.

7.62 While this approach appears to allow the acceptance of bundles in principle, the difficulty is in setting criteria for their review which do balance consumer interest and competition effectively. We would welcome Stakeholder views on this issue.

7.63 It may also be appropriate to link any development in this area to KCOM improvement in systems supporting retail competition.

[101] http://www.erg.eu.int/doc/meeting/erg_06_33_remedies_common_position_june_06.pdf

Question 7.4 How would you view a proposal for a new bundled service in Hull mixing narrowband and other services at reduced total cost? What is your view of the options presented for considering such a proposal? If we were to consider allowing such a proposal what criteria would you consider necessary for the service to adhere to?

Section 8

Conclusions

Introduction

8.1 In this section we set out a summary of the conclusions of the review. We also demonstrate how our proposed remedies for the remaining SMP markets satisfies the legal tests for their imposition (or removal).

Summary of conclusions

8.2 Tables 8.1 set out a summary of the current market and SMP determinations as how they differ from the 2003 review.

Table 8.1: Summary of conclusions on market definition and market power

<table>
<tr><th>2003 Markets</th><th>SMP BT</th><th>SMP KCOM</th><th>2009 Proposed Markets</th><th>SMP BT</th><th>SMP KCOM</th></tr>
<tr><td>Residential fixed narrowband access</td><td>Yes</td><td>Yes</td><td>Residential fixed narrowband access</td><td>No</td><td>Yes</td></tr>
<tr><td>Business fixed narrowband access</td><td>Yes</td><td>Yes</td><td>Business fixed narrowband access</td><td>No</td><td>Yes</td></tr>
<tr><td>Residential ISDN2 access</td><td>Yes</td><td>Yes</td><td>N/A</td><td>N/A</td><td>N/A</td></tr>
<tr><td>Business ISDN2 access</td><td>Yes</td><td>Yes</td><td>Business ISDN2 access</td><td>Yes</td><td>Yes</td></tr>
<tr><td>ISDN30 access</td><td>Yes</td><td>Yes</td><td>ISDN30 access</td><td>Yes</td><td>Yes</td></tr>
<tr><td>Residential fixed local calls</td><td>Yes</td><td>Yes</td><td rowspan="5">Residential fixed calls

Single market for all calls</td><td rowspan="5">No</td><td rowspan="5">Yes</td></tr>
<tr><td>Residential fixed national calls</td><td>Yes</td><td>Yes</td></tr>
<tr><td>Residential fixed international calls</td><td>Yes</td><td>Yes</td></tr>
<tr><td>Residential fixed calls to mobile</td><td>Yes</td><td>Yes</td></tr>
<tr><td>Residential fixed operator assisted calls</td><td>Yes</td><td>Yes</td></tr>
<tr><td>Business fixed local calls</td><td>Yes</td><td>Yes</td><td rowspan="5">Business fixed calls

Single market for all calls</td><td rowspan="5">No</td><td rowspan="5">Yes</td></tr>
<tr><td>Business fixed national calls</td><td>Yes</td><td>Yes</td></tr>
<tr><td>Business fixed international calls</td><td>No</td><td>Yes</td></tr>
<tr><td>Business fixed calls to mobile</td><td>Yes</td><td>Yes</td></tr>
<tr><td>Business fixed operator assisted calls</td><td>Yes</td><td>Yes</td></tr>
</table>

8.3 As shown our recommendations are largely deregulatory. We consider that BT no longer holds an SMP position in the analogue access markets or calls markets.

8.4 We consider that BT retains an SMP position in the ISDN2 and ISDN30 markets but we consider that it is appropriate to rely on wholesale remedies alone in addressing market failure in those markets.

8.5 For Hull, we do not consider that the market conditions have altered substantially. While KCOM is experiencing some increased competition it still holds SMP in those markets and we consider the continuation of the existing SMP remedies is appropriate.

Legal tests

Tests for modifications of SMP conditions and directions from the Communications Act

8.6 As noted, in section 2 and Annex 7 in order to impose SMP conditions we need to satisfy a number of tests set out under the Communications Act. We consider that our proposals meet the tests set out in the Communications Act. Our reasoning is set out below for each of the proposed conditions set out in Annex 8.

8.7 We also consider that it is appropriate to consider the legal test in respect to the removal of the SMP retail remedies (and reliance solely on wholesale remedies) for the SMP determination on BT for the ISDN2 and ISDN30 markets, in that we are obliged to impose appropriate regulation on markets in which a finding of SMP is made. In assessing what remedies are "appropriate" we believe that it is important to assess the existing remedies, in light of our assessment of the market.

8.8 We are proposing that BT no longer holds SMP in a number of markets. Section 84(4) of the Communications Act requires that, where such a finding is made we, "must revoke every SMP services condition applied to that person by reference to the market power determination made on the basis of the earlier analysis". Where we propose a finding of no SMP in a market, we will be proposing that all existing SMP conditions are revoked in accordance with the requirement in section 84(4).

<u>BT ISDN2 and ISDN30 Markets</u>

8.9 We will deal with both these market proposals together as the arguments for the removal of the remedies are the same.

8.10 Section 3 of the Communications Act imposes general duties on Ofcom, in carrying out its functions, to further the interests of citizens in relation to communications matters and of consumers in relevant markets, where appropriate by promoting competition. The Section also requires us to consider the interests of consumers in respect of choice, price, quality of service and value for money

8.11 We consider that our proposed removal of retail remedies fulfil these general duties under section 3 of the Communications Act as we consider that there is insufficient price and service competition in this mature market and that the existing remedies discourage such competition, by allowing price following of the SMP provider and discouraging BT from cutting prices and innovation in service.

8.12 Section 4 of the Communications Act sets out the Community requirements on Ofcom which flow from Article 8 of the Framework Directive. In considering which, if any, SMP services conditions to propose, Ofcom has taken account of all of these requirements. In particular, Ofcom has considered the requirement to promote competition and to secure efficient and sustainable competition for the benefit of consumers.

8.13 We have placed particular emphasis on the promotion of competition, which we consider is likely to be the most effective way of furthering citizen and consumer interests in the markets under review.

8.14 We will always seek the least intrusive regulatory measures to achieve its policy objectives, in accordance to its duty under section 6 of the Communications Act to minimise the burden of regulation. Given this approach and the requirement to promote competition we consider that the removal of retail remedies is appropriate and justifiable.

8.15 In addition to the overarching objective referred to above, we have taken into account a number of secondary objectives, including

- *Prices*: to ensure that services are available at prices that are reasonably related to the efficient costs of supply, preferably as a result of effective competition; and

- *Investment and innovation*: to promote efficient investment in the development of new and innovative service.

8.16 We carried out a full regulatory impact assessment in relation to the proposals for ISDN2 and ISDN30 as required by section 7 of the Communications Act. This is set out in section 7.

Section 91 test

8.17 We have been able to review the remedies proposed on these markets at the wholesale level in the parallel review. We consider that, in order to address the market failures we have identified, the proposed wholesale remedies are also the appropriate remedies for the retail markets.

8.18 Section 91 requires that retail level remedies authorised by that section shall only be applied where “Ofcom are unable, by the setting of conditions of the sorts specified in subsection (3) to perform, or fully perform, their duties under section 4 in relation to the market situation in the relevant market.” (section 91(2))

8.19 The conditions specified in subsection (3) are access related conditions and SMP conditions authorised or required by sections 87 to 90. Such conditions include the conditions proposed in the related wholesale review.

8.20 We consider that those proposed conditions are sufficient for us to fully perform our section 4 duties. Further we have considered whether additional remedies would add to or assist us in our compliance with section 4. We do not consider this to be the case. In particular we have reviewed the current remedies imposed. We have taken into account that the wholesale review is consulting on price regulation conditions for the ISDN30 wholesale market. However, we consider that the absence of a firm proposal on this single issue, having analysed the remedies as a whole, does not affect our decision at the retail level.

8.21 The nature of the ISDN2 and ISDN30 markets, which are characterised by a fixed size and stable customer base and price following by other providers, are such that the requirement on BT to publish price and non-discriminate leads to reluctance by BT to compete, least the value of the market falls for BT and other Communications Providers. A removal of the remedies and a reliance on wholesale remedies should introduce the opportunity for BT and other Communications Providers to actively compete on a contract by contract basis with a long term benefit for all customers. The section 4 duty to promote competition is, therefore, better served by not imposing additional retail remedies.

8.22 We, therefore, consider that, whilst we have found SMP in both the ISDN2 and ISDN30 retail markets, the test in section 91(2) is not satisfied and we should not set additional conditions at the retail level.

EC Guidelines

8.23 The Commission's SMP Guidelines state, at paragraphs 21 and 114, that NRAs must impose one or more SMP conditions on a dominant provider. This reflects Article 16(4) of the Framework Directive which states that NRAs "shall on such undertakings [with SMP] impose appropriate specific regulatory obligations". We consider that in proposing that the appropriate SMP remedies for the identified markets are at the wholesale level we are compliant with the principles of the Framework Directive and the SMP Guidelines. This is consistent with Article 17 of the Universal Service Directive which restricts the imposition of specific retail remedies to situations where wholesale remedies are not effective (the same test is essentially repeated in section 91 of the Communications Act, as described above).

8.24 In proposing the removal of retail remedies for ISDN2 and ISDN30, set out above, Ofcom is, therefore, satisfied that it has considered all of the relevant requirements of the Communications Act.

KCOM Markets

8.25 Below we will consider the proposed SMP remedies for the markets KCOM has SMP. We consider that the justification for individual remedies applies equally to each of the markets. For that reason, we will set out the tests for each remedy and then confirm to which markets the remedy applies.

8.26 Given the discussion above, we would also wish to confirm that we consider that, in the case of KCOM, we do not consider that it is sufficient to rely on wholesale remedies, as the level of competition in the Hull market is so limited that retail remedies are still required to encourage competition entry.

SMP Condition no undue discrimination condition

8.27 Given KCOM's SMP position our view is that KCOM should be required not to discriminate unduly between retail customers in the following markets in Hull:

- Residential analogue exchange line services;
- Business analogue exchange line services;
- Business ISDN2 exchange line services;
- Business ISDN30 exchange line services;
- Residential calls;
- Business calls;

8.28 In the 2003 review, we considered how we should treat undue discrimination in its implementation. We consider that this remedy does not mean that there should not be any differences in treatment between undertakings, rather that any differences should be objectively justifiable and/or not have a material adverse effect on competition for example, by differences in underlying costs of supplying different undertakings.

Section 3 test

8.29 As noted above, Section 3 of the Communications Act imposes general duties on Ofcom, in carrying out its functions, to further the interests of citizens in relation to communications matters and of consumers in relevant markets, where appropriate by promoting competition. The Section also requires us to consider the interests of consumers in respect of choice, price, quality of service and value for money

8.30 We consider that our proposed condition on non undue discrimination fulfils these general duties under section 3 of the Communications Act as there is a risk that a provider with SMP may exercise undue discrimination against a particular person or persons. In general, a provider can be said to be discriminating when it applies dissimilar conditions to equivalent transactions.

8.31 Such discrimination may be in various forms including price offers, terms and conditions or information. Such behaviour would represent undue discrimination if it has no objective justification eg if it has a material adverse effect on competition.

8.32 We consider that this condition is appropriate given the level of competition in the markets where KCOM has SMP. Competition law alone cannot be relied upon to prevent certain pricing strategies that could restrict the development of competition. The condition will enable Ofcom to carry out its duties to promote competition and the interests of citizens by prohibiting such undue discrimination.

Section 4 tests

8.33 In proposing this condition we have considered those requirements set out in Section 4 of the Communications Act to act in accordance with the Commission requirements.

8.34 By preventing undue discrimination, it meets the first requirement to promote competition and the third requirement to protect the interests of EU citizens.

Section 47 tests

8.35 We consider that the proposed condition meets the tests set out in Section 47 of the Communications Act.

8.36 It is justifiable, in that it is required to ensure that KCOM does not exploit its market power by discriminating unduly in the retail markets in which they have SMP.

8.37 It does not discriminate unduly against KCOM because, although it only applies to them, they have SMP and it is justified to impose the condition only on them. Where providers have SMP, discrimination can be effectively applied by the provider in question. Without market power, discrimination can be undermined by competitors or customers and attempted discrimination would not be considered undue.

8.38 It is proportionate in that it does not prevent the application of dissimilar conditions to different transactions where there are objective reasons for doing so. It is therefore the least burdensome means of achieving its aim.

8.39 We consider we have met the requirement of transparency set out in the Communications Act by setting out the proposed requirements on KCOM and the justification for the condition.

Section 91(2)

8.40 We also consider that the condition meets the test set out in Section 91(2) of the Communications Act. We do not consider that the current state of competition in the Hull markets would allow us to rely on wholesale remedies alone. Those remedies have, so far, not enabled or encouraged sufficient competitive entry. Accordingly, we consider that we continue to require retail remedies to address the concerns set out above.

SMP condition to notify charges terms and conditions

8.41 Ofcom has wide powers to seek specific information needed to assess allegations of anti-competitive behaviour. However, some general and reliable visibility of a dominant operator's prices is needed, however, to enable both us and competitors to monitor those prices for possible anti competitive behaviour.

8.42 We, therefore, propose to require KCOM to publish charges, terms and conditions, including bundled services and to publish amendments and new charges, terms and conditions within 24 hours of the time that those amendments or new charges, terms and conditions come into force including notification to Ofcom.

8.43 The requirement would apply to KCOM in respect of the following markets in the Hull area:

- Residential analogue exchange line services;
- Business analogue exchange line services;
- Business ISDN2 exchange line services;
- Business ISDN30 exchange line services;
- Residential calls;
- Business calls;

Section 3 test

8.44 As noted above, Section 3 of the Communications Act imposes general duties on Ofcom, in carrying out its functions, to further the interests of citizens in relation to communications matters and of consumers in relevant markets, where appropriate by promoting competition. The Section also requires us to consider the interests of consumers in respect of choice, price, quality of service and value for money

8.45 We consider that our proposed conditions on price notification fulfil these general duties under section 3 of the Communications Act. This option provides certainty that charges, terms and conditions will be published and offers the benefits of notification for monitoring purposes without facilitating price following in accordance with our duties to promote competition and the interests of citizens.

8.46 We consider that this condition is appropriate given the level of competition in the markets where KCOM has SMP.

Section 4 tests

8.47 In proposing this condition we have considered those requirements set out in Section 4 of the Communications Act to act in accordance with the Commission requirements.

8.48 Ensure price visibility, it meets the first requirement to promote competition and the third requirement to protect the interests of EU citizens.

Section 47 tests

8.49 We consider that the proposed condition meets the tests set out in Section 47 of the Communications Act. The justification for imposing the condition is that general and reliable visibility of a dominant operator's prices enables Ofcom and competitors to monitor the dominant operator's prices for possible anti competitive behaviour.

8.50 Imposition of this condition does not discriminate unduly against KCOM as they are the only operator in the market with SMP; the behaviour of other operators is not capable of having a materially adverse effect on competition as these operators do not have market power.

8.51 The remedy is proportionate, as it is the least burdensome means of achieving the objective, and the requirement is made fully transparent in the condition which is published at Annex 8 to this document.

8.52 We also consider that the condition meets the tests set out in Section 91(2) of the Communications Act as we set out above.

Question 8.1 Do you consider that our proposed remedies meet the tests set out under the Communications Act?

Question 8.2 Do you have any general comments on the market review conclusions or remedies proposed?

Annex 1

Responding to this consultation

How to respond

A1.1 Ofcom invites written views and comments on the issues raised in this document, to be made **by 5pm on 28 May 2009**.

A1.2 Ofcom strongly prefers to receive responses using the online web form at http://www.ofcom.org.uk/consult/condocs/retail_markets/howtorespond/form, as this helps us to process the responses quickly and efficiently. We would also be grateful if you could assist us by completing a response cover sheet (see Annex 3), to indicate whether or not there are confidentiality issues. This response coversheet is incorporated into the online web form questionnaire.

A1.3 For larger consultation responses - particularly those with supporting charts, tables or other data - please email markham.sivak@ofcom.org.uk attaching your response in Microsoft Word format, together with a consultation response coversheet.

A1.4 Responses may alternatively be posted or faxed to the address below, marked with the title of the consultation.

Markham Sivak
Competition Policy Group
Riverside House
2A Southwark Bridge Road
London SE1 9HA

Fax: 020 77834109

A1.5 Note that we do not need a hard copy in addition to an electronic version. Ofcom will acknowledge receipt of responses if they are submitted using the online web form but not otherwise.

A1.6 It would be helpful if your response could include direct answers to the questions asked in this document, which are listed together at Annex 4. It would also help if you can explain why you hold your views and how Ofcom's proposals would impact on you.

Further information

A1.7 If you want to discuss the issues and questions raised in this consultation, or need advice on the appropriate form of response, please contact Markham Sivak on 020 7783 4659.

Confidentiality

A1.8 We believe it is important for everyone interested in an issue to see the views expressed by consultation respondents. We will therefore usually publish all responses on our website, www.ofcom.org.uk, ideally on receipt. If you think your response should be kept confidential, can you please specify what part or whether all of your response should be kept confidential, and specify why. Please also place such parts in a separate annex.

A1.9 If someone asks us to keep part or all of a response confidential, we will treat this request seriously and will try to respect this. But sometimes we will need to publish all responses, including those that are marked as confidential, in order to meet legal obligations.

A1.10 Please also note that copyright and all other intellectual property in responses will be assumed to be licensed to Ofcom to use. Ofcom's approach on intellectual property rights is explained further on its website at http://www.ofcom.org.uk/about/accoun/disclaimer/

Next steps

A1.11 Following the end of the consultation period, Ofcom intends to publish a statement in July 2009.

A1.12 Please note that you can register to receive free mail Updates alerting you to the publications of relevant Ofcom documents. For more details please see: http://www.ofcom.org.uk/static/subscribe/select_list.htm

Ofcom's consultation processes

A1.13 Ofcom seeks to ensure that responding to a consultation is easy as possible. For more information please see our consultation principles in Annex 2.

A1.14 If you have any comments or suggestions on how Ofcom conducts its consultations, please call our consultation helpdesk on 020 7981 3003 or e-mail us at consult@ofcom.org.uk . We would particularly welcome thoughts on how Ofcom could more effectively seek the views of those groups or individuals, such as small businesses or particular types of residential consumers, who are less likely to give their opinions through a formal consultation.

A1.15 If you would like to discuss these issues or Ofcom's consultation processes more generally you can alternatively contact Vicki Nash, Director Scotland, who is Ofcom's consultation champion:

Vicki Nash
Ofcom
Sutherland House
149 St. Vincent Street
Glasgow G2 5NW

Tel: 0141 229 7401
Fax: 0141 229 7433

Email vicki.nash@ofcom.org.uk

Annex 2

Ofcom's consultation principles

A2.1 Ofcom has published the following seven principles that it will follow for each public written consultation:

Before the consultation

A2.2 Where possible, we will hold informal talks with people and organisations before announcing a big consultation to find out whether we are thinking in the right direction. If we do not have enough time to do this, we will hold an open meeting to explain our proposals shortly after announcing the consultation.

During the consultation

A2.3 We will be clear about who we are consulting, why, on what questions and for how long.

A2.4 We will make the consultation document as short and simple as possible with a summary of no more than two pages. We will try to make it as easy as possible to give us a written response. If the consultation is complicated, we may provide a shortened Plain English Guide for smaller organisations or individuals who would otherwise not be able to spare the time to share their views.

A2.5 We will consult for up to 10 weeks depending on the potential impact of our proposals.

A2.6 A person within Ofcom will be in charge of making sure we follow our own guidelines and reach out to the largest number of people and organisations interested in the outcome of our decisions. Ofcom's 'Consultation Champion' will also be the main person to contact with views on the way we run our consultations.

A2.7 If we are not able to follow one of these principles, we will explain why.

After the consultation

A2.8 We think it is important for everyone interested in an issue to see the views of others during a consultation. We would usually publish all the responses we have received on our website. In our statement, we will give reasons for our decisions and will give an account of how the views of those concerned helped shape those decisions.

Annex 3

Consultation response cover sheet

A3.1 In the interests of transparency and good regulatory practice, we will publish all consultation responses in full on our website, www.ofcom.org.uk.

A3.2 We have produced a coversheet for responses (see below) and would be very grateful if you could send one with your response (this is incorporated into the online web form if you respond in this way). This will speed up our processing of responses, and help to maintain confidentiality where appropriate.

A3.3 The quality of consultation can be enhanced by publishing responses before the consultation period closes. In particular, this can help those individuals and organisations with limited resources or familiarity with the issues to respond in a more informed way. Therefore Ofcom would encourage respondents to complete their coversheet in a way that allows Ofcom to publish their responses upon receipt, rather than waiting until the consultation period has ended.

A3.4 We strongly prefer to receive responses via the online web form which incorporates the coversheet. If you are responding via email, post or fax you can download an electronic copy of this coversheet in Word or RTF format from the ‘Consultations’ section of our website at www.ofcom.org.uk/consult/.

A3.5 Please put any parts of your response you consider should be kept confidential in a separate annex to your response and include your reasons why this part of your response should not be published. This can include information such as your personal background and experience. If you want your name, address, other contact details, or job title to remain confidential, please provide them in your cover sheet only, so that we don’t have to edit your response.

Cover sheet for response to an Ofcom consultation

BASIC DETAILS

Consultation title:

To (Ofcom contact):

Name of respondent:

Representing (self or organisation/s):

Address (if not received by email):

CONFIDENTIALITY

Please tick below what part of your response you consider is confidential, giving your reasons why

Nothing	☐	Name/contact details/job title	☐
Whole response	☐	Organisation	☐
Part of the response	☐	If there is no separate annex, which parts?	

If you want part of your response, your name or your organisation not to be published, can Ofcom still publish a reference to the contents of your response (including, for any confidential parts, a general summary that does not disclose the specific information or enable you to be identified)?

DECLARATION

I confirm that the correspondence supplied with this cover sheet is a formal consultation response that Ofcom can publish. However, in supplying this response, I understand that Ofcom may need to publish all responses, including those which are marked as confidential, in order to meet legal obligations. If I have sent my response by email, Ofcom can disregard any standard e-mail text about not disclosing email contents and attachments.

Ofcom seeks to publish responses on receipt. If your response is non-confidential (in whole or in part), and you would prefer us to publish your response only once the consultation has ended, please tick here. ☐

Name

Signed (if hard copy)

Annex 4

Consultation question

Question 4.1 Do you agree with our proposed market determinations for the UK excluding Hull and for Hull? If not, please provide reasons and your alternative proposals for the market structures?

Question 5.1 Do you agree with the analysis set out above for the residential analogue access markets in the UK excluding the Hull area which found that BT does not have SMP? If not, please provide reasons.

Question 5.2 Do you agree with the analysis set out above for the residential analogue access markets in the Hull area which found that KCOM continues to have SMP? If not, please provide reasons.

Question 5.3 Do you agree with the analysis set out above for the business analogue access markets in the UK excluding the Hull area which found that BT does not have SMP? If not, please provide reasons.

Question 5.4 Do you agree with the analysis set out above for the business analogue access markets in the Hull area which found that KCOM continues to have SMP? If not, please provide reasons.

Question 5.5 Do you agree with the analysis set out above for the ISDN2 market in the UK excluding the Hull area which found that BT continues to have SMP? If not, please provide reasons.

Question 5.6 Do you agree with the analysis set out above for the ISDN2 market in the Hull area which found that KCOM continues to have SMP? If not, please provide reasons.

Question 5.7 Do you agree with the analysis set out above for the ISDN30 market in the UK excluding the Hull area which found that BT continues to have SMP? If not, please provide reasons.

Question 5.8 Do you agree with the analysis set out above for the ISDN30 market in the Hull area which found that KCOM continues to have SMP? If not, please provide reasons.

Question 6.1 Do you agree with the analysis set out above for the residential calls market in the UK excluding the Hull area which found that BT does not have SMP? If not, please provide reasons.

Question 6.2 Do you agree with the analysis set out above for the residential calls market in the Hull area which found that KCOM continues to have SMP? If not, please provide reasons.

Question 6.3 Do you agree with the analysis set out above for the business calls market in the UK excluding the Hull area which found that BT does not have SMP? If not, please provide reasons.

Question 6.4 Do you agree with the analysis set out above for the business calls market in the Hull area which found that KCOM continues to have SMP? If not, please provide reasons.

Question 7.1 Do you agree with our assessment of the likely impacts of deregulations? What, if any, changes to our current procedures/approach do you consider we should adopt in the light of the deregulation?

Question 7.2 Do you agree with our assessment of the characteristics of the ISDN2 and ISDN30 markets? Subject to your assessment of the markets, do you agree with the proposed removal of retail remedies for ISDN2 and ISDN30 and reliance on wholesale remedies alone?

Question 7.3 Do you agree with our continued imposition of retail price publication and no undue discrimination remedies on KCOM in Hull? If not, please state your reasons and your suggestion of the appropriate response to the SMP findings?

Question 7.4 How would you view a proposal for a new bundled service in Hull mixing narrowband and other services at reduced total cost? What is your view of the options presented for considering such a proposal? If we were to consider allowing such a proposal what criteria would you consider necessary for the service to adhere to?

Question 8.1 Do you consider that our proposed remedies meet the tests set out under the Communications Act?

Question 8.2 Do you have any general comments on the market review conclusions or remedies proposed?

Annex 5

Assessment of market power - additional analysis of the call markets

Introduction

A5.1 In this annex we look at different segments within the call markets in more detail as part of the market power assessment. At the end of this annex we also present the market shares and revenue per minute for all calls combined (i.e. geographic, international, call to mobile and other call types). As noted in section 6 we excluded ‘other’ calls from the main analysis of market shares and revenue per minute because this category includes dial up internet minutes which have declined rapidly as consumers have moved form narrowband to broadband internet access.

Individual call segments – residential call market

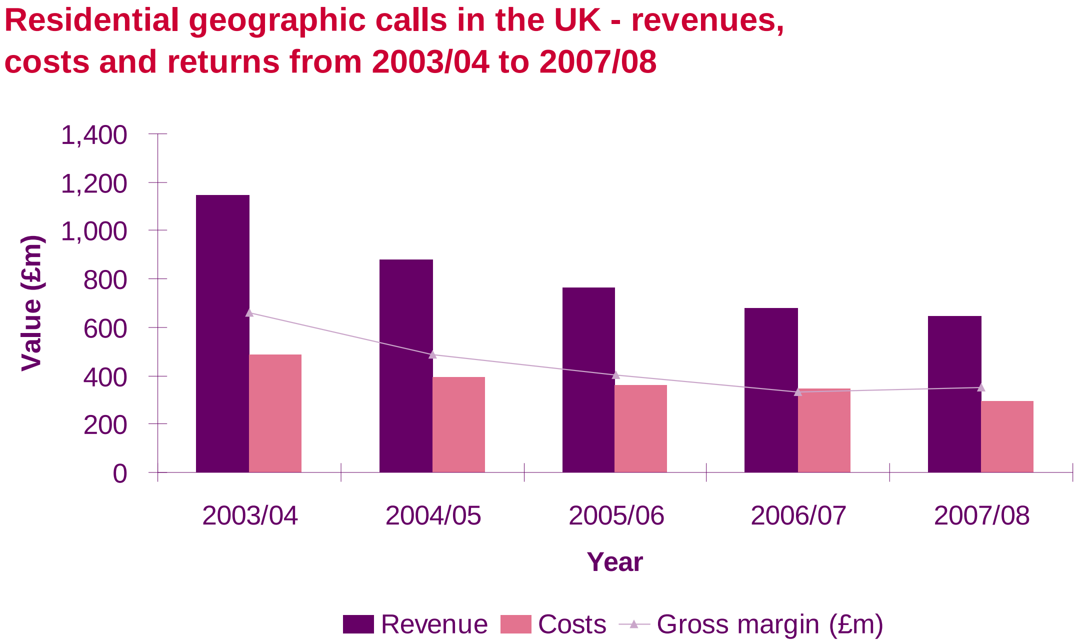
A5.2 As noted in section 4 we have defined a single calls market but recognise that there are different competitive constraints for each call type. In the following section we analyse the information on profitability, pricing (revenue per minute) and market share for each of the main call types – geographic, call to mobile and international. This additional analysis is only carried out for the markets we are proposing to deregulate (i.e. for the UK area excluding Hull).

Geographic calls

Pricing and profitability

A5.3 The figure below shows BT’s costs, revenues and gross margin for geographic calls in nominal terms. Gross margin has fallen since the last review.

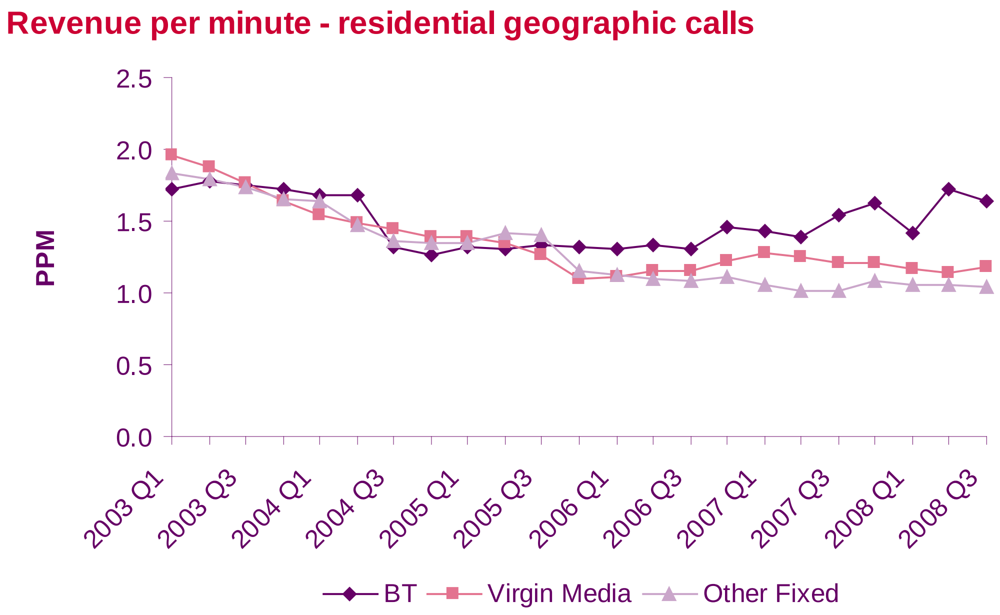
Figure A5.1



Source: BT regulatory accounts

A5.4 In nominal terms, BT's RPM for geographic calls decreased from 2003-2005 but has generally risen since 2007 (see figure below). The increase in RPM since 2007 might reflect the package changes instigated by BT as described above. Most of BT's packages now include some 'free' geographic calls. The relationship between revenue and volume is likely to be weaker for geographic calls (since revenues are partially fixed irrespective of volumes). Despite the rise over recent time the RPM is still at a similar nominal level to 2003 (i.e. about 1.7p per minute) and has fallen in real terms relative to 2003.

Figure A5.2



Source: Ofcom/operators

Market shares

A5.5 The market shares data[102] for geographic calls shows a similar picture for all calls as discussed in section 6. There has been a fall in BT's market share of minutes and revenues, with market share of minutes declining faster than revenues.

A5.6 BT's market share of minutes has fallen fairly steadily since 2003 and we might expect this trend to continue. However, the market share of revenues has been broadly stable since 2005.

Table A5.3 Market shares for residential geographic calls

	Volumes			Revenues		
	BT	Virgin	Other fixed	BT	Virgin	Other fixed
2003	72%	18%	10%	71%	19%	10%
2004	65%	19%	16%	66%	19%	15%
2005	59%	20%	21%	60%	19%	21%
2006	54%	20%	26%	58%	19%	23%
2007	53%	19%	29%	60%	18%	23%
2008 Q1	50%	19%	31%	56%	18%	26%
2008 Q2	49%	19%	33%	60%	15%	25%
2008 Q3	48%	18%	34%	58%	16%	27%

Source: Ofcom/operators

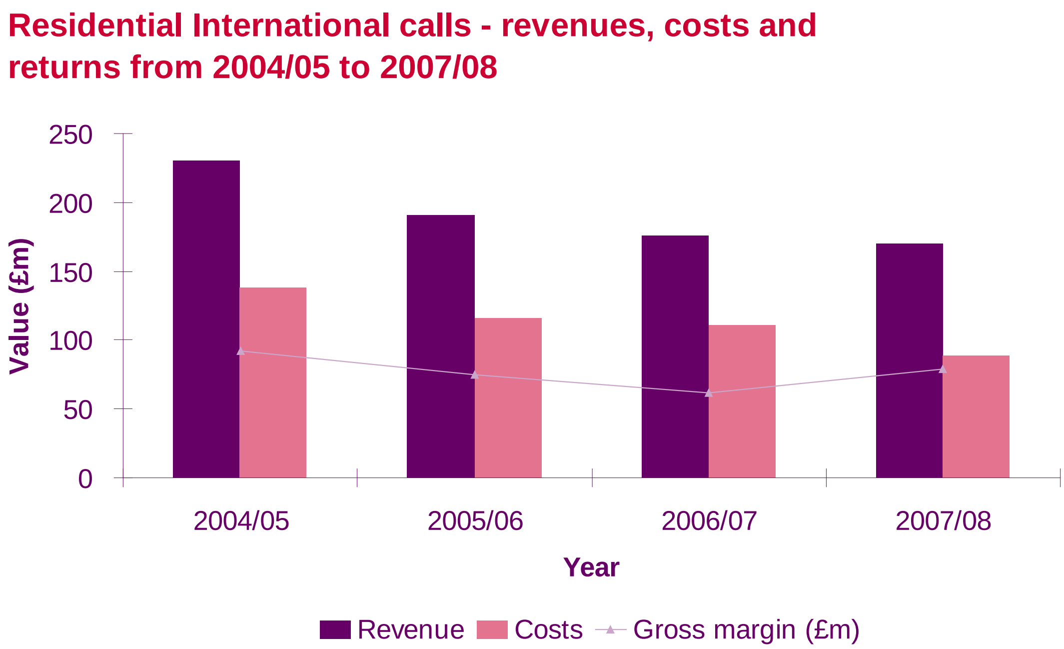
[102] While we use the term "market shares" to discuss sales within the segment, this should not be interpreted as an indication that we treat geographic calls as a separate product market.

International direct dial calls

Pricing and profitability

A5.7 The figure below shows BT's costs, revenues and gross margin for international calls in nominal terms. Gross margin declined from 2004/5 to 2006/7 but increased in 2007/8. Overall gross margin has fallen since the last review.

Figure A5.4



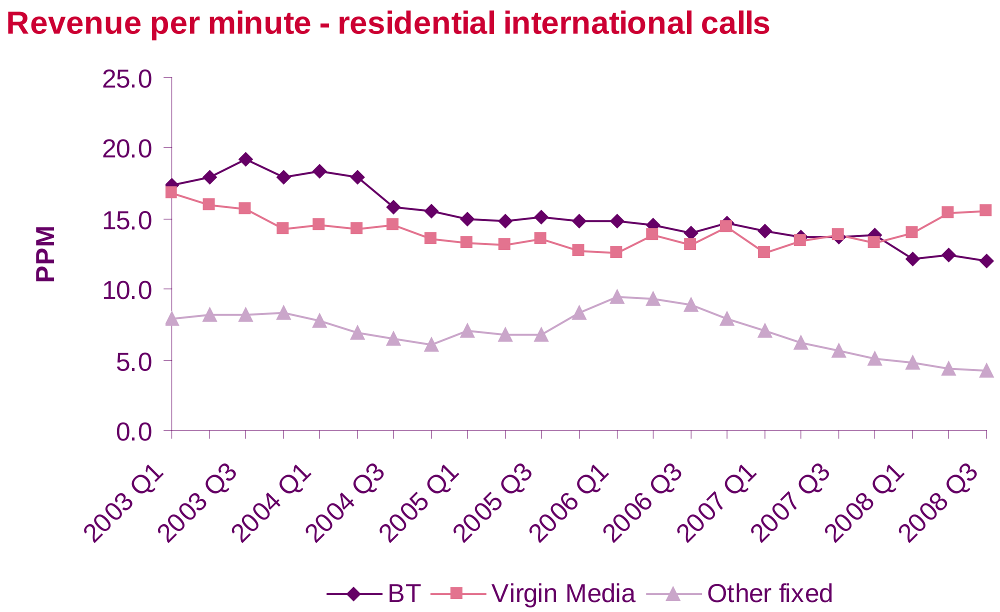
Source: Ofcom/operators

A5.8 RPM (shown in the graph below) has decreased in nominal terms since 2003. However, it is notable that BT's RPM is higher than other fixed providers (although lower than Virgin). This could be because other fixed operators are particularly aggressive in pricing international calls e.g. they use this to differentiate their offers from BT. Alternatively BT might find it profitable to charge a higher price because their customers are likely to be less price sensitive e.g. if BT's users of international calls are more commonly lower volume convenience users who do not make many calls and are prepared to pay a higher price. High volume users are more likely to have switched away from BT to find a better deal or use an alternative means of communication (e.g. email or calling cards).

A5.9 Email is likely to be a stronger constraint on international than geographic calls, particularly where immediate contact is not essential. Our market research showed that 57% of people would use the internet as their first choice for keeping in touch with friends and family abroad, compared with 24% who would use internet as their first choice to keep in touch with friends and family in the UK. This is an additional pricing constraint on international calls, particularly as the marginal price of email is often zero[103].

[103] The majority of internet users have a broadband or unmetered narrowband package based on a fixed subscription fee.

Table A5.5



Source: Ofcom/operators

Market shares

A5.10 At the time of the last review BT's share of residential international calls was lower than that for other calls types. BT's market shares of both minutes and revenues have continued to decline. BT's relatively low share of volumes probably reflects a higher propensity to switch for international calls. BT's share of revenues is substantially higher than their share of volumes (50% versus 31%).

Table A5.6 Market shares for residential international calls

	Volumes			Revenues		
	BT	Virgin	Other fixed	BT	Virgin	Other fixed
2003	52%	11%	37%	67%	12%	22%
2004	49%	11%	40%	66%	13%	22%
2005	45%	11%	44%	59%	13%	28%
2006	43%	10%	46%	54%	12%	35%
2007	37%	9%	53%	54%	13%	33%
2008 Q1	33%	9%	58%	50%	15%	34%
2008 Q2	32%	8%	60%	50%	16%	34%
2008 Q3	31%	7%	61%	50%	15%	35%

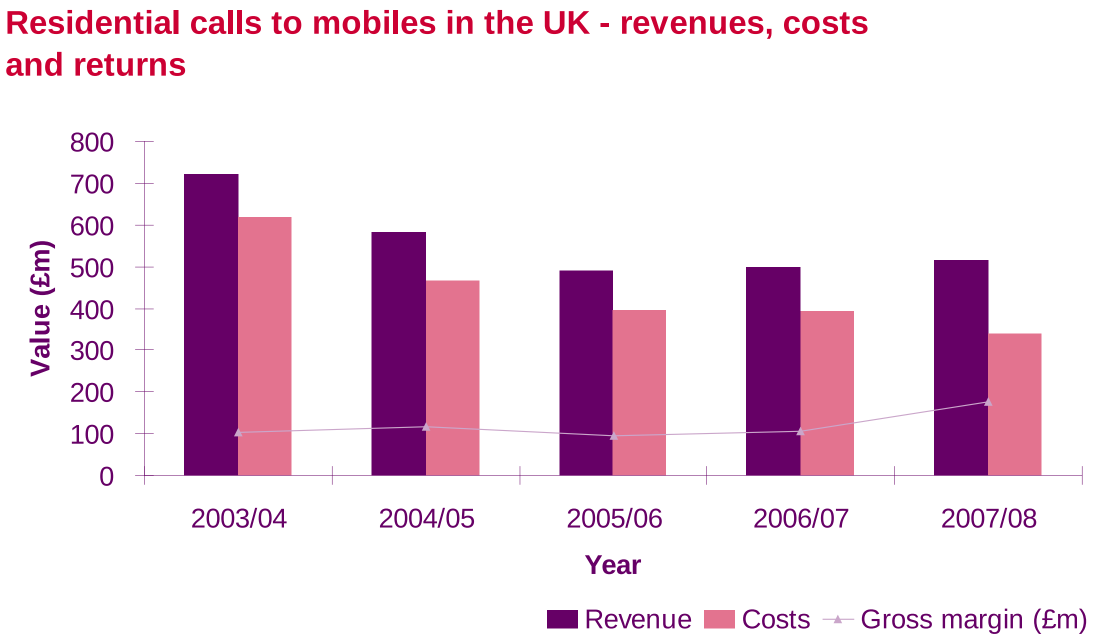
Source: Ofcom/operators

Calls to mobile

Pricing and profitability

A5.11 The figure below shows BT's costs, revenues and gross margin for calls to mobile in nominal terms. Gross margin has increased in the last year.

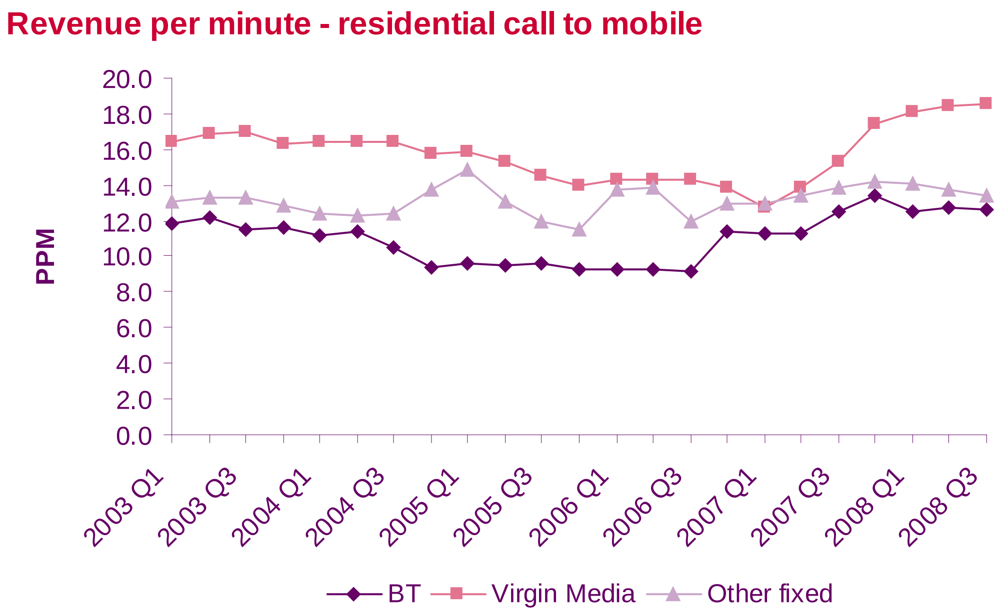
Figure A5.7



Source: BT regulatory accounts

A5.12 BT's nominal RPM (shown in the graph below) decreased from 2003 to 2005. From 2005 to Q3 2006 RPM was broadly flat. Over 2007 RPM increased, although it has subsequently stabilised at around 12.6ppm over 2008. BT's RPM has been consistently below that of Virgin and other fixed providers.

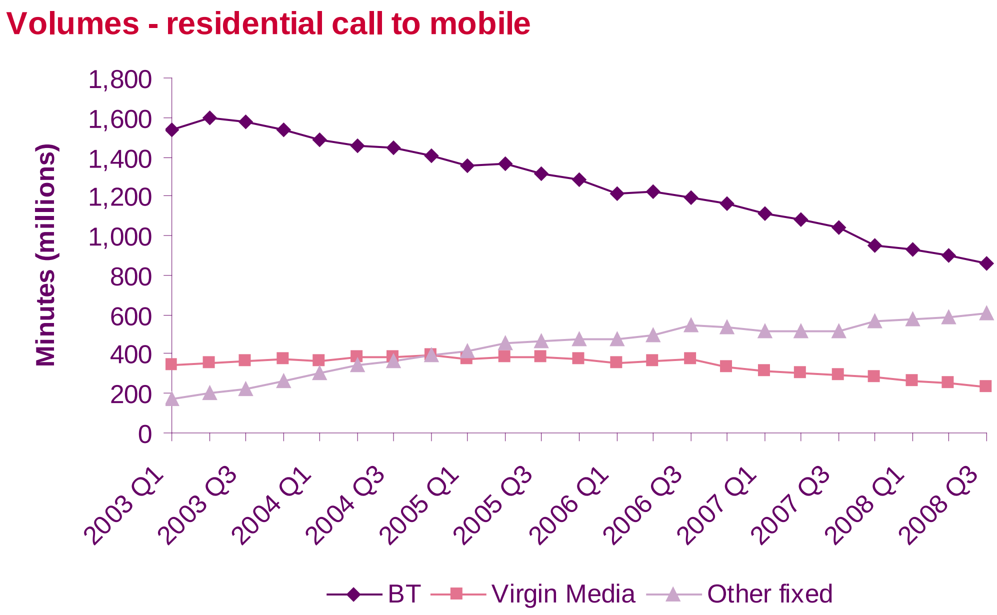
Figure A5.8



Source: Ofcom/operators

A5.13 The overall volume of fixed to mobile minutes has fallen since the last review as a result of mobile substitution (see figure below). The pricing constraint from mobile operators is probably stronger for call to mobile relative to other call types. Calls to mobile are generally not included as part of the inclusive package for fixed line calls. However, mobile pay monthly packages (and increasing pay as you go deals) usually include some mobile calls as part of the fixed subscription or in return for a fixed regular top up. For consumers that own both mobile and fixed access it makes sense to use up the inclusive mobile to mobile minutes before using the fixed line to make mobile calls.

Figure A5.9



Source: Ofcom/operators

Market shares

A5.14 BT's share of residential fixed calls to mobile have declined significantly since the last review in terms of both minutes and revenues.

Table A5.10 Market shares for residential call to mobile

	Volumes			Revenues		
	BT	Virgin	Other fixed	BT	Virgin	Other fixed
2003	73%	17%	10%	68%	22%	10%
2004	67%	17%	16%	59%	24%	17%
2005	61%	18%	21%	52%	23%	24%
2006	58%	17%	25%	50%	22%	29%
2007	56%	16%	28%	52%	18%	30%
2008 Q1	52%	15%	33%	47%	19%	33%
2008 Q2	52%	15%	34%	47%	19%	34%
2008 Q3	51%	14%	35%	47%	19%	35%

A5.15 The Consumer Market Research suggested, on the whole, that mobile calls were perceived to be more expensive than landline calls. The exception to this was calls to the same mobile network where landline calls were thought to be more expensive.

A5.16 However, there were significant differences in the perception of call costs between pay as you go and pay monthly customers. Pay monthly customers are less likely to say that mobile calls cost less than landlines for local, national, on network and off-network calls. This may be linked to the high level of inclusive cross-network minutes on some pay monthly tariffs. The increase in the proportion of mobile users on pay monthly contracts (from 30% in 2005 to around 40% in 2008[104]) is likely to have contributed to the reduction in BT's call volumes (particularly for call to mobile). If this trend continues it is probably that BT's volumes for call to mobile and geographic calls will fall further.

Individual call markets – business

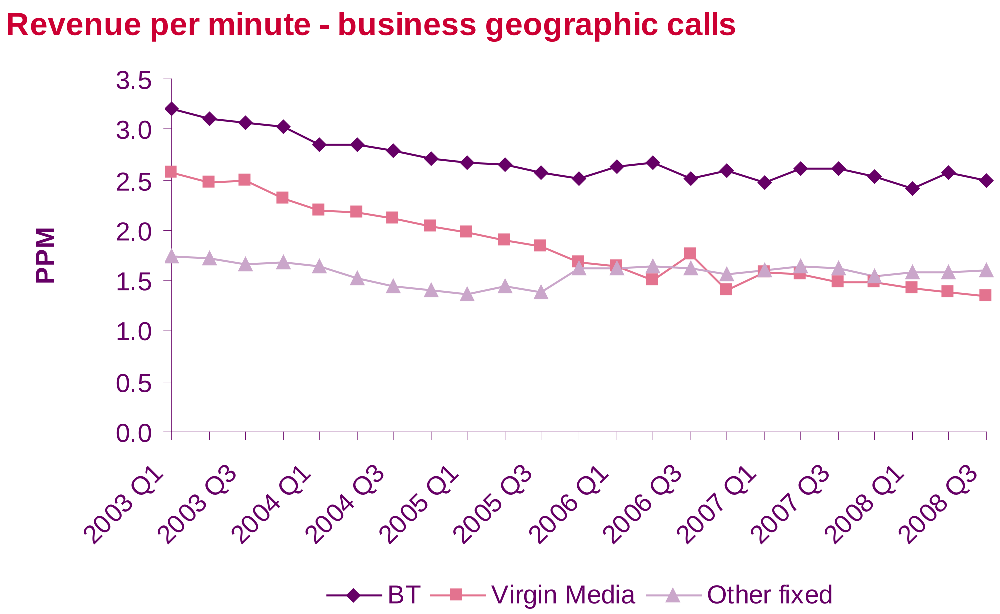
A5.17 As noted in section 4 we have defined a single calls market but recognise that there are different competitive constraints for each call type. In the following section we analyse the information on pricing (revenue per minute) and market share for each of the main call types – geographic, call to mobile and international. This additional analysis is only carried out for the markets we are proposing to deregulate (i.e. for the UK area excluding Hull).

Geographic calls

Pricing

A5.18 In nominal terms BT's RPM has decreased slightly since 2003 (figure below). However, it remains above that of other fixed providers and Virgin. As discussed above, this might reflect the strategy of competitors (i.e. undercutting BT's prices to increase market share). The RPM for other providers has moved broadly in line with BT, which might suggest that other providers use BT's published pricing as a benchmark. If this is the case BT has less incentive to lower prices because any move would be transparent to the market and likely to be followed by their competitors (assuming that the price still covers marginal cost).

Figure A5.11



Source: Ofcom/operators

[104] Source: The Consumer Experience 2008

Market share

A5.19 BT's market share for geographic calls has fallen in terms of both minutes and revenues since 2003. BT's share of minutes is now relatively low (<40%), however, the share of revenues is higher at 48%. This might suggest that BT is able to charge a higher price than alternative suppliers, as discussed above.

Table A5.12 Market shares for business geographic calls

	Volumes			Revenues		
	BT	Virgin	Other fixed	BT	Virgin	Other fixed
2003	44%	7%	49%	57%	7%	35%
2004	42%	7%	51%	56%	7%	37%
2005	40%	7%	53%	54%	7%	40%
2006	39%	7%	55%	50%	5%	44%
2007	38%	7%	55%	50%	5%	45%
2008 Q1	38%	6%	55%	49%	5%	46%
2008 Q2	38%	6%	55%	50%	4%	45%
2008 Q3	37%	6%	56%	48%	5%	47%

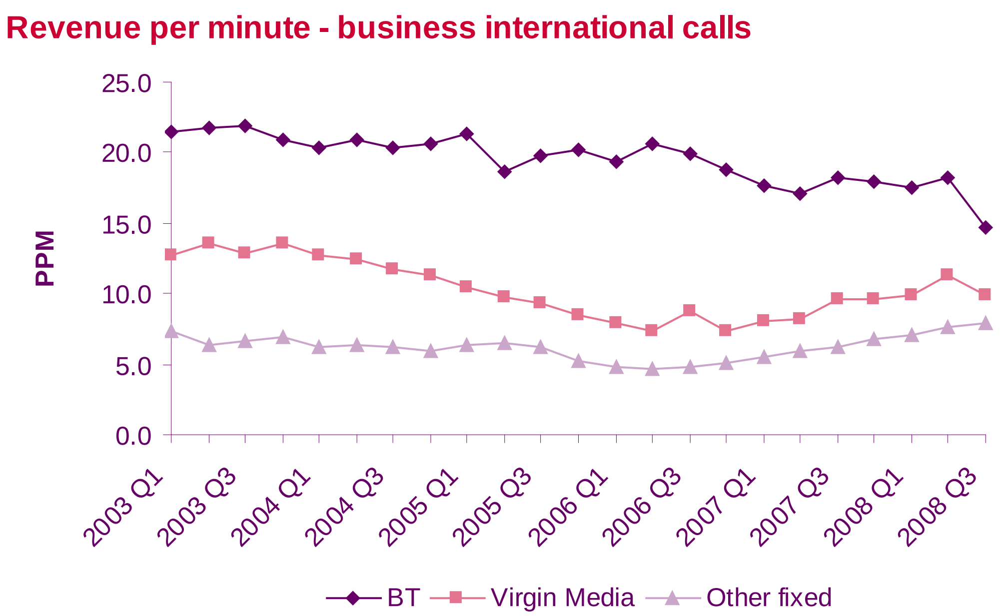
Source: Ofcom/operators

International calls

Pricing

A5.20 In nominal terms BT's RPM has decreased since 2003. It remains above that of other fixed providers and Virgin although it appears that RPM is converging through time. This might suggest that BT is reducing real prices in response to the competitive constraint imposed by other providers.

Figure A5.13



Source: Ofcom/operators

Market share

A5.21 BT's market shares for international calls have fluctuated since the last review without making significant change in either direction. The market share of minutes has increased slightly (+3%) but remains at a low level (24%). The market share of revenues increased from 2003-2006 but subsequently declined and was at a lower level in Q3 2008 (36%) than 2003 (46%).

Table A5.14 Market shares for business international calls

	Volumes			Revenues		
	BT	Virgin	Other fixed	BT	Virgin	Other fixed
2003	21%	2%	76%	46%	3%	51%
2004	21%	3%	77%	46%	4%	51%
2005	23%	3%	74%	49%	3%	48%
2006	22%	3%	76%	52%	3%	45%
2007	22%	2%	76%	45%	2%	53%
2008 Q1	23%	2%	75%	42%	2%	56%
2008 Q2	24%	2%	73%	43%	3%	55%
2008 Q3	24%	2%	74%	36%	2%	61%

Source: Ofcom/operators

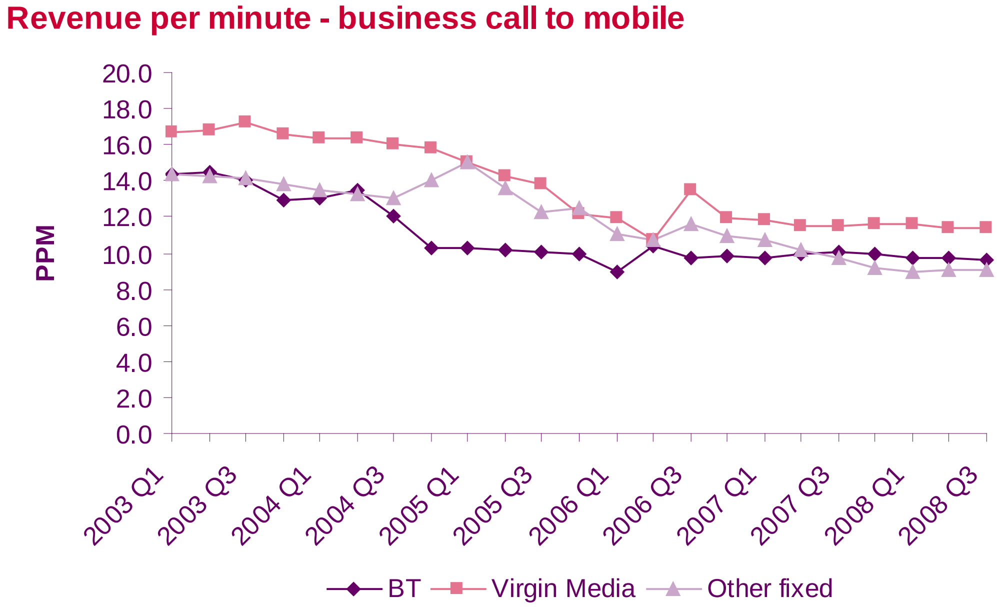
A5.22 Falling RPM combined with a decreasing market share of revenues and a relatively low share of minutes suggests that BT is not able to price international calls above the competitive level.

Call to mobile

Pricing

A5.23 In nominal terms BT's RPM has generally decreased since 2003. The RPM for BT and other fixed providers have been very similar since 2007. This might suggest there is a common pricing constraint e.g. the price of mobile to mobile calls. Falling RPM and the possibility of substitution to mobile suggest that BT's ability to price above the competitive level in this market segment is limited.

Figure A5.15



Source: Ofcom/operators

Market shares

A5.24 BT's shares of minutes and revenues have not changed significantly since the last review. BT might have lost less market share in this market segment because their pricing is relatively competitive (i.e. RPM for BT and other fixed is similar as shown above).

Table A5.16 Market shares for business call to mobile

	Volumes			Revenues		
	BT	Virgin	Other fixed	BT	Virgin	Other fixed
2003	44%	6%	49%	44%	8%	49%
2004	44%	6%	50%	41%	8%	52%
2005	44%	6%	50%	37%	7%	55%
2006	43%	6%	51%	39%	7%	54%
2007	44%	6%	50%	44%	7%	50%
2008 Q1	44%	5%	51%	45%	7%	48%
2008 Q2	43%	5%	52%	44%	6%	49%
2008 Q3	42%	5%	53%	43%	6%	51%

Source: Ofcom/operators

All residential calls

A5.25 The table below shows BT's market share for all residential calls (including other calls[105] and dial up internet minutes). The decrease in BT's share of minutes is in part due to the decline in the number of dial up internet minutes since the last Review (BT's minute volumes comprised proportionately more dial up minutes because they include calls made to non-BT internet service providers via FRIACO). BT's share of revenues has fallen at a slower rate than the share of minutes because dial up internet calls were charged at a low pence per minute.

[105] Other calls includes freephone, special services, premium rate, directory enquiries and all other call types. BT figures include calls made to non-BT internet service providers via FRIACO.

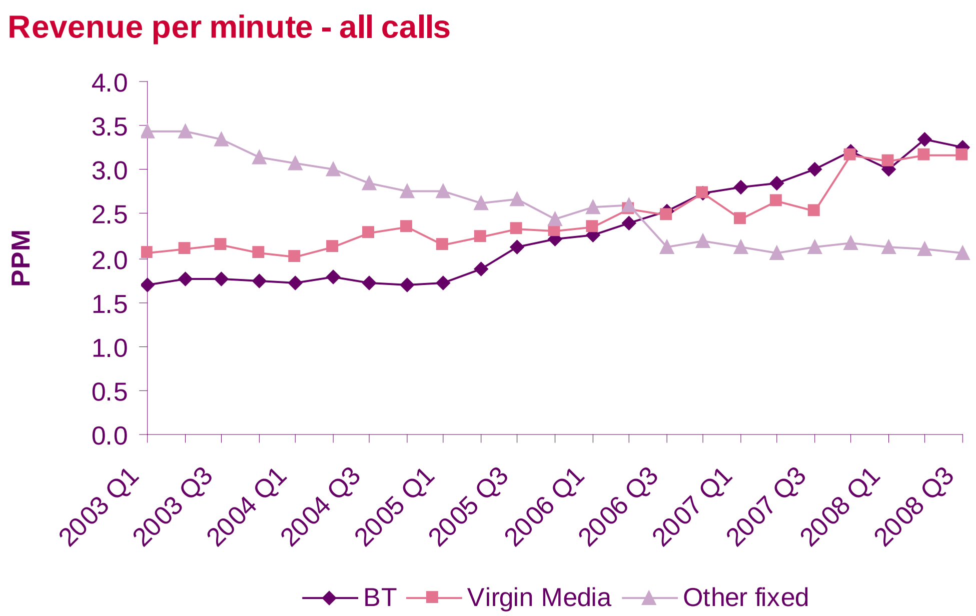
Table A5.17 Market shares of all residential calls

	Volumes			Revenues		
	BT	Virgin	Other fixed	BT	Virgin	Other fixed
2003	78%	15%	7%	71%	17%	12%
2004	74%	16%	10%	67%	18%	15%
2005	67%	17%	16%	62%	18%	19%
2006	60%	18%	22%	60%	19%	22%
2007	55%	18%	27%	61%	18%	21%
2008 Q1	52%	17%	31%	57%	19%	24%
2008 Q2	50%	17%	33%	57%	19%	24%
2008 Q3	49%	17%	35%	56%	19%	25%

Source: Ofcom/operators

A5.26 The figure below shows BT's RPM for all calls. The increase in RPM from 2005 onwards in part reflects the decline in the number of dial up internet minutes which were charged at low pence per minute (e.g. free if part of an unmetered subscription package or around 1ppm if part of a metered package). As the volume of dial up minutes has declined the average RPM has increased.

Figure A5.18



Source: Ofcom/operators

All business calls

A5.27 The table and figure below shows BT's market share and RPM for all business calls (including other calls[106] and dial up internet minutes). The comments made above relating to dial up internet minutes also apply here, but to a lesser extent because businesses are more likely to use alternative services for internet access.

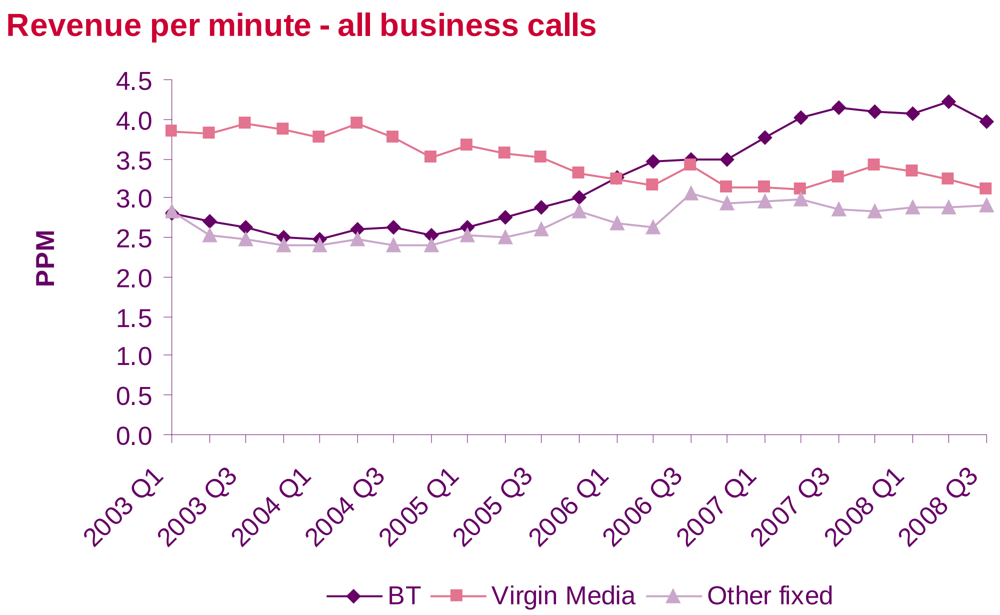
[106] Other calls includes freephone, special services, premium rate, directory enquiries and all other call types. BT figures include calls made to non-BT internet service providers via FRIACO.

Table A5.19 - Market shares of all business calls

	Volumes			Revenues		
	BT	Virgin	Other fixed[107]	BT	Virgin	Other fixed
2003	51%	5%	44%	51%	7%	42%
2004	49%	4%	46%	49%	7%	44%
2005	46%	5%	49%	47%	6%	46%
2006	44%	6%	51%	48%	6%	46%
2007	42%	6%	52%	49%	6%	45%
2008 Q1	41%	6%	53%	49%	6%	45%
2008 Q2	40%	6%	54%	49%	5%	45%
2008 Q3	39%	6%	55%	46%	5%	48%

Source: Ofcom/operators

Figure A5.20



Source: Ofcom/operators

[107] Other fixed includes direct and indirect access.

Annex 6

Review of the removal of residential retail price controls

Introduction

A6.1 The objective of this annex is to set out our review of how retail prices for BT products have changed since the Retail Price Control lapsed in July 2006.

A6.2 The RPCs applied to the spending patterns of the lowest 80% of residential customers and to a basket of residential services in retail markets where we had found BT to have SMP. The effect of the controls, which at the time of their removal was set at RPI+0%, was that BT could not increase charges for the basket of services in real terms (i.e. overall retail prices could not increase by more than RPI). The controls excluded the impact of increased volumes of activity.

Approach and summary of results

A6.3 To address the impact of the removal of RPCs, the preferred option would have been a recalculation of the price date in the same manner as one undertaken during the period of the controls. However, as the nature of the products under offer had been substantially altered and the monitoring process had not been maintained we were required to consider an appropriate proxy set of data which would provide an equivalent picture of the movement of charges.

A6.4 The data requested from BT was a year on year comparison of movement in average total bill per customer when the impact of volume is excluded (August 2007 – July 2008 data is compared with August 2006 – July 2007 data). Excluding the impact of volume replicates the former compliance data as we considered that BT had complied with the RPC if total current year revenue from the basket of services at preceding year volumes, did not rise by more than the change in RPI.

A6.5 The analysis has focused on how retail prices have changed for three groups:

- the bottom 80% of BT residential customers by spend (i.e., the proportion of BT customers that were previously protected by the RPCs);
- the bottom 30% of BT customers by spend (the BT customers considered most vulnerable to unregulated price rises); and
- Light User Scheme (LUS) customers, the BT package that acts a safeguard for residential customers with low telephone usage.

A6.6 The data provided by BT captures two specific aspects – call bill and line rental/package fees and discounts – to ascertain movements in average total bills for each decile of the BT customer base. BT provided indicative data in June last year that demonstrated its residential prices for 06/07 increased at a rate below that of RPI (at 2.7% when RPI increased by 3.3%).

A6.7 BT provided two data sets – one including the Payment Processing Fee (PPF) and one excluding the PPF. BT charges the PPF to customers who do not pay their bill by Direct Debit or through a monthly payment plan. The PPF came into effect on 1 May

2007 and equates to an extra £18 per year if customers do not pay in the stipulated manner.

A6.8 The following table presents the year on year percentage change in average total bill for BT residential customers:

Percentage change in average total bill

	Bottom 3 deciles	Bottom 3 deciles (non LUS)	Bottom 8 deciles	All BT customers	LUS
Including PPF	-0.2	1.3	2.2	3.6	-1.5
Excluding PPF	-3.5	-1.9	-0.6	1.5	-5.9

A6.9 The RPI increase used to measure these results is taken at as at the previous June – in line with the old RPC – and is 4.4%. Therefore, the increase in average total bill excluding volume related variance for all categories of customers was below that of the rise in RPI. This is below the maximum level BT could have charged had the RPCs still been in effect at the same level as in July 2006.

A6.10 BT has indicated that the move to BT Basic will not alter the results for the LUS customers on qualifying benefits (Income Support, Job Seekers Allowance and Pension Credit) who will be migrated across to this new package for low usage customers.

A6.11 BT attributes the sub-RPI increases in residential prices to the effects of competition and the result of package optimisation. In discussions with Ofcom, BT noted that over the period covered by the data it has released numerous special offers that attempt to direct customers into their optimal package.

A6.12 The increase in line rental and introduction of PPF since the RPCs were allowed to lapse does have a impact on average total bills. However, the analysis confirms , these appear to have been offset to a degree by package optimisation, option fees and package discounts.

A6.13 BT also provided data based on typical customer profiles. In this data, BT states that when the PPF is included, Option 1 customers have seen an increase of 6.3% (£1.14/month) in their average total bill (excluding volume variance). This data would appear to suggest that there are Option 1 customers who are not product maximizing. In responding to this result, BT noted that 17% of Option 1 customers are in the top 2 deciles. As such, BT believe that these customers contributed significantly to the rise in average total bills for Option 1 customers over this period.

A6.14 We have not directly analysed the movement in average bills for the top 20% of BT customers by spend as these customers were not previously protected by the RPCs. However, it appears that this group has experienced a significant rise in average total bills. Excluding PPF, the average total bill for the bottom 8 deciles decreases by 0.6% over 07/08. The total change (all BT customers) is a 1.5% increase in average total bill. Therefore, the change in the average total bill for the top 2 deciles has contributed 2.1 percentage points to the overall change. Including PPF, this contribution is 1.4 percentage points.

A6.15 Detailed methodology is set out below

Detailed methodology

A6.16 The data provided by BT is a year on year comparison of movement in average total bills since the removal of price controls (August 2006 – July 2007 compared with August 2007 – July 2008). The data captures two specific residential aspects – call bill and line rental/package fees and discounts – to ascertain movements in average bills for each decile of the BT customer base.

A6.17 The current data provided by BT varies from the data BT was obligated to provide whilst the RPCs were still in effect. The RPC was applied to the spending patterns of the lowest 80% of residential customers and based on a basket of residential services in specified retails markets in the UK where BT was found to have SMP. The previous data was based on a requirement on BT to demonstrate compliance with this control and concentrated on changes in ppm on a year on year basis within call packages.

A6.18 BT provided data based on the bottom 8 deciles, the bottom 3 deciles and Light User Scheme (LUS) customers. The bottom 8 deciles corresponds approximately with the proportion of BT customers previously covered by the RPCs (bottom 80%); the bottom 3 deciles are the group of customers considered the most vulnerable to price rises; and LUS is a calling plan that gives a rebate for residential customers with low telephone usage.

A6.19 Deciles are tenths of customer total bill revenue with boundaries defined by the value of the maximum bill size within each decile. Each decile will not sum to exactly 10% of the BT customer base. This is because a group of customers close to or on a boundary will have the same size bill.

A6.20 In this data, LUS customers comprise 17% of the customers in the bottom 3 deciles while Option 1 customers comprise 70% of the customers in these deciles.

A6.21 Two data sets are provided by BT – one including the Payment Processing Fee (PPF) and one excluding the PPF. The PPF is the charge on BT customers who do not pay their bill by Direct Debit or through a monthly payment plan.

A6.22 The first element of the data provided examines movement in average call bill due to price, package mix and volume. Price variance is the change in call price year on year multiplied by the current years minutes. Package mix variance measures the movement in revenue year on year due to changes in time of day and package mix. Volume variance is the balance of movement in average call bill less that due to price and that due to package mix.

A6.23 The second element of the data measures the movement in average bill excluding calls. That is, the impact on an average bill by changes to line rental/package fees and discounts.

A6.24 The movement in average total bill is the sum of gross calls and changes to line rental/package fees and discounts. Volume is disaggregated from this measure so as not to distort the final analysis (that is, BT should not be penalised if an increase in average bill was the result of a higher volume of calls).

Results

A6.25 Movement in average call bill due to price, package mix and volume remained the same for both worksheets as PPF is introduced in the second element of the data with rental/package fees and discounts. The movement in each separate factor assumes the other two remain constant.

A6.26 The movement in average call bill due to price for the bottom 3 deciles and bottom 8 deciles is, respectively, a 1p and 56p increase per month per customer. The total movement in average call bill due to price is a £1.12 increase (that is, the movement in average call bill attributed to price for all BT residential customers) . LUS customers average call bill increased by 3p per month per customer as a result of changes to volume.

A6.27 The movement in average call bill due to package mix for the bottom 3 deciles and bottom 8 deciles is, respectively, a 19p and 26p decrease per month per customer. The total movement in average call bill due to package mix is a £0.19 decrease. LUS customers average call bill is not changed by changes to package mix (LUS customers are migrated to Option 1 if call charges exceed a threshold amount on 3 consecutive quarterly bills).

A6.28 The movement in average call bill due to volume for the bottom 3 deciles is a 16p increase per month per customer. The movement in average call bill due to volume for the bottom 8 deciles is a 37p decrease per month per customer. The total movement in average call bill due to volume is a 96p decrease. LUS customers average call bill decreased by 9p per month per customer as a result of changes to volume.

A6.29 The change in average bills per month attributed to changes to line rental/package fees and discounts remains constant across both sets. By decile, these changes are a 14p decrease per month for customers in the bottom 3 deciles, a 38p decrease for customers in the bottom 8 deciles and a 65p decrease for all customers overall. LUS customers average call bill decreased by 46p per month as a result of changes to line rental/package fees and discounts.

<u>PPF</u>

A6.30 When including PPF into the calculations, the percentage change excluding volume variance was a 0.2% decrease for average total bills in the bottom 3 deciles, a 2.2% increase for bills within the bottom 8 deciles and a 3.6% increase in the average total bill for all BT customers. The average total bill for a LUS customer decreased by 1.5%.

A6.31 Movement in average bill due to the PPF was 30p/month for the bottom 3 deciles, 40p/month for the bottom 8 deciles and 42p/month for all BT customers. The difference between the bottom 3 and bottom 8 deciles is attributed to the removal of PPF for LUS customers in February 2008.

<u>Exc.-PPF</u>

A6.32 The percentage change excluding volume variance was a 3.5% decrease for average total bills in the bottom 3 deciles, a 0.6% decrease for bills within the bottom 8 deciles and a 1.5% increase in the average total bill for all BT customers. The average total bill for a LUS customer decreased by 5.9%.

Annex 7

Legal Framework

A7.1 The present regulatory framework for electronic communications networks and services entered into force on 25 July 2003. The framework is designed to create harmonised regulation across Europe and is aimed at reducing entry barriers and fostering prospects for effective competition to the benefit of consumers. The basis for the regulatory framework is five EU Communications Directives (together "the Directives"):

- Directive 2002/21/EC on a common regulatory framework for electronic communications networks and services ("Framework Directive");
- Directive 2002/19/EC on access to, and interconnection of, electronic communications networks and associated facilities ("Access Directive");
- Directive 2002/20/EC on the authorisation of electronic communications networks and services ("Authorisation Directive");
- Directive 2002/22/EC on universal service and users' rights relating to electronic communications networks and services , ("Universal Service Directive"); and
- Directive 2002/58/EC concerning the processing of personal data and the protection of privacy in the electronic communications sector ("Privacy Directive").

A7.2 This framework is currently being reviewed, but the Community legislation has yet to adopt legislative proposals.

The Communications Act 2003

A7.3 The Framework Directive, the Access Directive, the Authorisation Directive and the Universal Service Directive were implemented in the United Kingdom on 25 July 2003 via the Communications Act. The Privacy Directive was implemented by separate regulations which came into force on 11 December 2003.

A7.4 In particular part 2 of the Communications Act sets out the majority of that Act's provisions that implement the Directives. Sections 32, 45-50 and 78-90 are of particular importance. Ofcom is required to act in accordance with its general and specific duties in sections 3 and 4 of the Communications Act, respectively.

A7.5 Under section 3, Ofcom must, in carrying out its functions further the interests of citizens in relation to communications matters and the interests of consumers in relevant markets, where appropriate by promoting competition. As to the latter Ofcom must have regard, in particular, to the interests of those consumers in respect of choice, price, quality of service and value for money. This corresponds with the policy objective in Article 8(2) of the Framework Directive.

A7.6 Section 4 of the Communications Act requires that Ofcom acts in accordance with the six Community requirements set out at sections 4(3) to 4(9). Where it appears to Ofcom that its general duties conflict with its section 4 duties, priority must be given to the latter.

A7.7 Ofcom has, however, a wide measure of discretion in balancing its statutory duties and objectives including where they conflict. In doing so, Ofcom will take all relevant considerations into account, including consultation responses.

Market Reviews

A7.8 The Directives require National Regulatory Authorities ('NRA') to carry out reviews of competition in communications markets to ensure that regulation remains appropriate and proportionate in the light of changing market conditions.

A7.9 Each market review normally has three stages, namely:

- definition of the relevant markets;
- assessment of competition in each market, in particular whether any undertakings have SMP in a given market; and
- assessment of appropriate regulatory obligations where there has been a finding of SMP.

A7.10 The three stages will be summarised, in turn, below. More detailed requirements and guidance concerning the conduct of market reviews are provided in the EU Communications Directives, the Communications Act and in additional documents issued by the Commission, of which Ofcom are required to have taken utmost account.

A7.11 Table A7.1 below indicates the relevant legislative framework for each stage.

Table A7.1

Authority / Stage of Review	Communications Act 2003	EU Communication Directives	Other Guidance
Definition of Markets	s78-86 s84 (duty to review)	A15-16 Framework Directive	Commission Recommendation on Markets (2007)
SMP	S86 – only set on market review / no material change S78 – circumstances required for SMP conditions	A14 Framework Directive (definition : market power)	Commission SMP Guidelines (2002)
Remedies	S45-47 power to set condition; to whom they apply; test for setting / modifying S87-92 SMP service conditions : subject matter	A9-13 Access Directive A17-19 Universal Service Directive A16 Framework Directive	ERG Common Position on Remedies
Notification	S48-49; 79-80	Article 7 Framework Directive	Commission Recommendation on notifications (2008)

Market Definition Stage

A7.12 Section 79(1) of the Communications Act provides that, before making a market power determination, Ofcom must identify the market, which is, in its opinion, the one which, in the circumstances of the United Kingdom, is the market in relation to which it is appropriate to consider making such a determination and to analyse that market. The procedure is set out mainly in Article 15 of the Framework Directive and sections 78 to 86 of the Communications Act.

A7.13 Article 15(3) of the Framework Directive requires that NRAs shall, taking the utmost account of the Recommendation and SMP Guidelines published by the Commission, define the relevant markets *appropriate to national circumstances*, in particular relevant geographic markets within their territory, in accordance with the principles of competition law.

<u>The Recommendation on relevant product and services markets.</u>

A7.14 The Commission has, in accordance with Article 16 of the Framework Directive, issued a Recommendation on relevant markets where it identifies a set of product and service markets within the electronic communication sector, in which *ex ante* regulation may be warranted.

A7.15 The Recommendation seeks to promote harmonisation across the EC by ensuring that the same markets are subject to a market analysis in all Member States. NRAs are, however, able to regulate markets that differ from those identified in the Recommendation where this is justified by national circumstances and where the Commission does not raise any objections under Article 7(4) of the Framework Directive.

A7.16 Specifically the Commission has identified seven product and service markets within the electronic communication sector, in which *ex ante* regulation may be warranted. The Commission sets out the basis upon which it has identified those markets at para 2.2 of the Explanatory Memorandum (‘EM’) accompanying the Recommendation. They identify three specific cumulative criteria (‘the three criteria test’) that should be considered when identifying which markets are susceptible to *ex ante* regulation, where the relevant market(s) differ from those defined in the Recommendation. Those criteria are:

- Barriers to entry and to the development of competition

  The presence of high and non-transitory entry barriers is a necessary condition for a market to be susceptible to *ex ante* regulation. The Commission identify two types of barrier to entry, structural barriers and legal / regulatory barriers.

- Dynamic Aspects – no tendency to competition

  The market must demonstrate characteristics such that it will not tend towards effective competition without *ex ante* regulatory intervention. The application of this criteria involves examining the state of competition behind the barrier to entry, taking account of the fact that even when a market is characterised by high barriers to entry, other structural factors or market characteristics and developments may mean that the market tends towards effective competition.

- Relative efficiency of competition law and complementary *ex ante* regulation

  Ex ante regulation would be considered to constitute an appropriate complement to competition law in circumstances where the application of competition law would not adequately address the market failures concerned.

A7.17 The Commission adopted its first recommendation on 11 February 2003, defining seven retail level market and 11 wholesale level markets. Article 15(1) of the Framework Directive imposed an obligation upon the Commission to regularly review its Recommendation. The Commission reviewed the initial recommendation and, on 17 December 2007, adopted the second edition of the Recommendation, under which some markets in the 2003 Recommendation were removed or amended. The current 2007 Recommendation lists one retail level market and six wholesale level markets.

A7.18 In particular, the following markets relevant to this review has now been removed:

- Publicly available local and/or national telephone services provided at a fixed location for residential customers. (formerly market 3 in the 2003 Recommendation)
- Publicly available international telephone services provided at a fixed location for residential customers. (formerly market 4)
- Publicly available local and/or national telephone services provided at a fixed location for non-residential customers. (formerly market 5)
- Publicly available international telephone services provided at a fixed location for non-residential customers. (formerly market 6)

A7.19 The removal of the markets from the list published by the Commission indicates that the Commission no longer presumes that, in principle, *ex ante* regulation is warranted for these markets. This does not mean, however, that NRAs are not in a position after an analysis of the relevant market and the finding of SMP to impose regulatory remedies in these markets, should the national circumstances justify such a step and whilst taking due account of the Commission's SMP Guidelines and Recommendation.

A7.20 Article 16 of the Framework Directive requires each national regulatory authority (NRA) to carry out an analysis of the relevant markets as soon as possible after the adoption of the recommendation on relevant product and service markets ("the Recommendation") or any updating thereof.

Guidelines for market analysis and the assessment of SMP

A7.21 The Commission have also published guidelines on market analysis and the assessment of SMP (the "SMP Guidelines"). This guidance was published, in accordance with Article 15(2) of the Framework Directive, by the Commission in July 2002.

A7.22 Oftel published its own additional guidelines on the criteria to assess effective competition. These supplement the SMP Guidelines and have been taken into account where appropriate.

Ofcom's Approach to services market identifications

A7.23 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.

A7.24 In defining the markets in accordance with the principles of competition law, Ofcom's approach to service market identifications follows, to start with, that used by UK competition authorities and is in line with those used by European and US competition authorities.

A7.25 Market boundaries are determined by identifying constraints on the price setting behaviour of firms. There are two main competitive constraints to consider: how far it is possible for customers to substitute other services for those in question (i.e. demand side substitution); and how far suppliers could switch, or increase, production to supply the relevant products or services (i.e. supply-side substitution) following a price increase.

A7.26 In addition to the products 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. In sections X-Y Ofcom considers the geographic extent of each relevant market covered in this market review.

European Commission's approach to market definition

A7.27 In formulating its approach to market definition, Ofcom has taken due account of the Recommendation.

A7.28 The 4th recital to the Recommendation clearly states that the starting point for market definition is a characterisation of the retail market over a given time horizon, taking into account the possibilities for demand and supply side substitution. The wholesale market is identified subsequently to this exercise being carried out in relation to the retail market. This approach is repeated in section 3.1 of the EM and is exactly that set out above and followed by Ofcom.

A7.29 Section 2.1 of the EM also states that, because any market analysis is forward looking, markets are to be defined prospectively taking account of expected or foreseeable technological or economic developments over a reasonable horizon linked to the timing of the next market review. Again, this is the approach followed by Ofcom.

A7.30 Furthermore, section 2.1 of the EM states that market definition is not an end in itself, but a means to assessing effective competition for the purposes of *ex ante* regulation. Ofcom has adopted an approach by which this consideration is at the centre of its analysis. The purpose of market definition is to illuminate the situation with regard to competitive pressures. For example, Ofcom's approach to supply side substitution explicitly identifies as the key issue the question of whether additional competitive constraints on pricing are brought to bear by additional suppliers entering the market. Thus, the key issue is not the market definition for its own sake, but an identification of the extent and strength of competitive pressures.

A7.31 Also, section 4 of the EM states that retail markets should be examined in a way that is independent of the infrastructure being used, as well as in accordance with the principles of competition law. Again, this approach is key to Ofcom's analysis. As seen from the above, Ofcom's approach is based on a competition law assessment of markets and an assessment of the extent to which switching among services by consumers constrains prices, irrespective of the infrastructure used by the providers of those services.

A7.32 Ofcom's views, and the application of the Recommendation in this regard, are discussed for each of the individual proposed markets in Sections X-Y.

Market (SMP) Analysis Stage

General

A7.33 The second market review stage concerns the assessment of competition in each identified services market to decide whether any undertaking has SMP.

A7.34 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 only be imposed 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".

A7.35 Thus, Article 16 further prescribes, in effect, what regulatory action NRAs must take depending upon whether or not the market in question has been found effectively competitive. If it has, then NRAs are prohibited to impose specific (SMP) obligations and must withdraw such obligations where they exist. On the other hand, where the market is not effectively competitive, the NRAs must identify the undertakings with SMP on that market and shall impose on them appropriate obligations.

A7.36 Under the Communications Act, the process of designating an undertaking as having SMP is referred to as the making of a market power determination under section 79. To reflect the provisions in Article 16, there is a close link in this analysis with the imposition of remedies. This is because section 45 of the Communications Act details the various conditions that may be set. Section 46 of the Communications Act prescribes who those conditions may be imposed upon.

A7.37 In relation to SMP services conditions, section 46(7) provides that they may be imposed on a particular person who is a communications provider or a person who makes associated facilities available and who has been determined to have significant market power in a "services market" (i.e. a specific market for electronic communications networks, electronic communications services or associated facilities). Accordingly, having identified the relevant market, Ofcom is required to analyse the market in order to assess whether any person or persons have SMP as defined in section 78 of the Communications Act (Article 14 of the Framework Directive).

Approach used to assess SMP

A7.38 Under the EC Communications Directives and section 78 of the Communications Act, the concept of SMP is defined so that it is equivalent to the competition law concept of dominance. Article 14(2) of the Framework Directive provides: "[a]n 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".

A7.39 Further, Article 14(3) of the Framework Directive provides that: "[w]here 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".

A7.40 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.

A7.41 In assessing whether a Communication Provider has SMP in the relevant markets in question, Ofcom has taken the utmost account of the SMP Guidelines as well as Oftel's supplemental guidelines, as referred to above, in its market power assessment. In particular, the analyses in Sections X and Y provide an assessment of the SMP proposals made in this review against the criteria set out in those guidelines, such as market shares, ease of market entry, and economies of scale.

A7.42 The SMP Guidelines state:

> "NRAs will assess whether the competition is effective. A finding that effective competition exists on a relevant market is equivalent to a finding that no operator enjoys a single or joint dominant position on that market."[108]

A7.43 The SMP Guidelines go on to state:

> "NRAs will conduct a forward looking structural evaluation of the relevant market, based on existing market conditions. 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. The actual period used should reflect the specific characteristics of the market and the expected timing for the next review of the relevant market by the NRA. NRAs should take past data into account in their analysis when such data are relevant to the developments in that market in the foreseeable future."[109]

A7.44 In the SMP Guidelines, the EC discusses market shares as being an indicator of 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

[108] Paragraph 19
[109] Paragraph 20

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…"[110]

A7.45 However, the EC also notes that:

"It is important to stress that the existence of a dominant position cannot be established on the sole basis of large market shares. As mentioned above, the existence of high market shares simply means that the operator concerned might be in a dominant position. Therefore, 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. In that regard, the following criteria can also be used to measure the power of an undertaking to behave to an appreciable extent independently of its competitors, customers and consumers. These criteria include amongst others:

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

A dominant position can derive from a combination of the above criteria, which taken separately may not necessarily be determinative."[111]

The relationship between the market reviews and Competition Act 1998 and *Enterprise Act 2002 investigations*

A7.46 The economic analyses carried out in this document are for the purposes of determining whether an undertaking or undertakings have SMP in relation to the

[110] Paragraph 75
[111] Paragraphs 78-79

markets in question. It is without prejudice to any economic analysis that may be carried out in relation to any investigation or decision pursuant to the Competition Act 1998 or the Enterprise Act 2002.

A7.47 The fact that economic analysis carried out for a market review is without prejudice to future competition law investigations and decisions is recognised in Article 15(1) of the Framework Directive which provides that: "…The recommendation shall identify…markets…the characteristics of which may be such as to justify the imposition of regulatory obligations …without prejudice to markets that may be defined in specific cases under competition law…".

A7.48 Its intention is further evidenced in the SMP Guidelines, which state:

• Paragraph 25: "… Article 15(1) of the Framework Directive makes clear that the market to be defined by NRAs for the purpose of *ex ante* regulation are without prejudice to those defined by national competition authorities and by the Commission in the exercise of their respective powers under competition law in specific cases." (repeated in paragraph 37);

• Paragraph 27: "…Although NRAs and competition authorities, when examining the same issues in the same circumstances and with the same objectives, should in principle reach the same conclusions, it cannot be excluded that, given the differences outline above, and in particular the broader focus of the NRAs' assessment, markets defined for the purposes of competition law and markets defined for the purpose of sector-specific regulation may not always be identical"; and

• Paragraph 28: "…market definitions under the new regulatory framework, even in similar areas, may in some cases, be different from those markets defined by competition authorities."

A7.49 In addition, it is up to all providers to ensure that they comply with their legal obligations under all the laws applicable to the carrying out of their businesses. It is incumbent upon all providers to keep abreast of changes in the markets in which they operate, and in their position in such markets, which may result in legal obligations under the Competition Act 1998 or Enterprise Act 2002 applying to their conduct.

The need for ex ante regulation

Nature of the competition problem identified

A7.50 Before turning to the last stage market review stage concerning remedies, it is necessary to consider whether competition law remedies are sufficient to address the problem. This consideration is necessary to establish, in line with the abovementioned 27th recital to the Framework Directive, whether or not a market is

A7.51 effectively competitive. (In this context, it is to be noted that the importance of identifying that problem reappears under Article 8(4) of the Access and Interconnection Directive. This is because obligations imposed in accordance with Article 8 shall be based on the nature of the problem identified, proportionate and justified in the light of the objectives laid down in Article 8 of the Framework Directive.)

A7.52 Ofcom's own guidelines on Impact Assessment note that we will consider the option of no regulation in its impact assessment process.

A7.53 In this light, it is considered below whether *ex ante* regulation is justified in the identified markets or whether it would be sufficient to rely on competition law alone to address market failures.

Appropriate to promote the development of competition

A7.54 As a competitive market will produce a more efficient outcome than a regulated market, the promotion of competition is central to securing the best deal for the consumer in terms of quality, choice and value for money.

A7.55 Where markets are effectively competitive, ex post competition law is sufficient to deal with any competition abuses that may arise. However, without the imposition of *ex ante* regulations to promote actively the development of competition in a non-effectively competitive market, it is unlikely that ex post general competition law powers will be sufficient to ensure that effective competition becomes established. For example, this is because ex post powers prohibit abuse of dominance rather than the holding of a dominant position. *Ex ante* powers can be utilised to reduce the level of market power in a market and thereby encourage effective competition to become established.

A7.56 The risk is not all one way as use of some *ex ante* measures can themselves limit or add nothing to the development of competition. Ofcom has recognised this in removing some regulation where markets are not effectively competitive.

A7.57 Ofcom proposes that *ex ante* regulation is now no longer necessary in most, but not all, of the markets covered by this document and Notification.

A7.58 Where it is proposed that a market is not effectively competitive we have considered what regulation would be appropriate to remedy the identified problem. We are mindful that it is preferable to apply regulation at the wholesale level as this both addresses SMP issues in the wholesale markets and promotes competition in downstream markets that rely on wholesale inputs. This fits with the requirement that NRAs take measures which meet the objective of encouraging efficient investment in infrastructure and promoting innovation (see Article 8(2) of the Framework Directive and section 4 of the 2003 Communications Act). The regulation of wholesale markets encourages competing providers to purchase wholesale products and combine them with their own networks to create products in competition with the legacy operator.

A7.59 Article 17 of the Universal Service Directive restricts the imposition of regulatory controls on retails services to situations where obligations that could be imposed under the Access Directive or Framework Directive would not, in themselves be sufficient to achieve the objectives set out under article 8 of the Framework Directive. This restriction is repeated in section 91 of the Communications Act. In finding a retail market not to be effectively competitive Ofcom must therefore consider the effectiveness of access-related conditions and SMP condition imposed under sections 87 – 90 in related wholesale markets, when determining what remedies, if any, are appropriate at retail level.

Market dominance

A7.60 Although communications markets have in general become increasingly competitive over time, this is from a position in which most were controlled by a legacy monopoly operator. The increase in competition that has occurred inevitably reflects the imposition of *ex ante* regulation to counter the market power of the legacy operator. In some markets competition has increased sufficiently for Ofcom to propose that the legacy operator is no longer dominant. However, where Ofcom proposes that the legacy operator remains dominant it would be appropriate to continue to regulate these markets in order to ensure that effective competition can become established.

Remedies Stage

Subject matter of the SMP remedies

A7.61 The third and final market review stage concerns remedies. As noted above, Article 16 of the Framework Directive dictates the imposition or removal of SMP remedies depending upon whether or not a finding of SMP in an identified services market has been made. Where an SMP finding has been made, Ofcom will consider what appropriate SMP remedies are available.

A7.62 Under section 45 of the Communications Act, Ofcom is empowered generally to set SMP services conditions authorised or required by sections 87 to 92. The latter implement Articles 9 to 13 of the Access and Interconnection Directive and Articles 17 to 19 of the Universal Service Directive. In addition, Ofcom's power to set such conditions includes additional powers specified in section 45(10), such as powers to include provisions in SMP services conditions for Ofcom to make directions in respect of specified markets.

A7.63 The SMP obligations relevant to the markets covered by this document are discussed in Section 7.

A7.64 Section 46 of the Communications Act provides that SMP services conditions set under section 45 may only be applied if the person to whom they are to apply is a communications provider (or a person who makes associated facilities available) and is a person whom Ofcom has determined to be a person having SMP in a services market. It is therefore important to consider the precise identity of the regulated entity on whom it is appropriate to impose obligations.

Regulated entity

A7.65 As noted above, section 46 provides that a person to whom an SMP services condition is applied must be a 'communications provider' or a 'person' who makes associated facilities available and a 'person' who Ofcom has determined to have SMP in a specific market for electronic communications networks, electronic communications services or associated facilities (i.e. the 'services market').

A7.66 Article 16 of 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-5447), for example, where a company within that group is not independent in its decision making.

A7.67 Ofcom considers it appropriate to prevent a dominant provider to whom a SMP service condition is applied, which is part of a group of companies, 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. In this consultation Ofcom proposes that the following providers have SMP in at least one market;

- BT
- KCOM

The legal tests

A7.68 However, before Ofcom can set or modify SMP services conditions on such a regulated entity, it must be satisfied that certain legal tests have been satisfied in imposing the SMP condition in question.

A7.69 In Section 8 of this document, Ofcom sets out its reasons explaining why those tests would be satisfied based on evidence presently before Ofcom. In addition to need of satisfying the general and specific duties, the appropriateness of the remedy and identifying the nature of the competition problem mentioned above, Ofcom must satisfy a number of additional tests.

A7.70 First, under section 47(2) of the Communications Act, Ofcom must show for each and every SMP services condition that it is:

> • *objectively justifiable* in relation to the networks, services, facilities, apparatus or directories to which it relates;
>
> • *not such as to discriminate unduly* against particular persons or against a particular description of persons;
>
> • *proportionate* to what the condition or modification is intended to achieve;
>
> and
>
> • in relation to what it is intended to achieve, *transparent*.

A7.71 Secondly, in relation to retail markets, the test set out in section 91(2) of the Communications Act must be satisfied. That section requires that where Ofcom has made a finding of dominance in a retail market, they shall only set SMP conditions if [they] are unable, by the setting of conditions of the sorts specified in subsection (3), to perform, or fully perform, their duties under section 4 in relation to the market situation in the relevant market.

A7.72 Subsection 3 reads;

> The sorts of conditions referred to in subsection (2) are –
>
> a) access-related conditions; and
>
> b) SMP conditions authorised or required by sections 87 to 90

ERG Common Position on Remedies

A7.73 At a plenary meeting on 18/19 May 2006, the European Regulators Group ("ERG") adopted a revised version of its document entitled 'Revised ERG Common Position on the approach to Appropriate remedies in the new regulatory framework', ERG (06) 33, (the "Common Position on Remedies").

A7.74 That document sets out NRAs' views on imposing remedies in a manner that contributes to the development of the internal market and ensures a consistent application of the new regulatory framework under the EC Communications

Directives.

A7.75 Ofcom has therefore taken into account those views in proposing appropriate remedies.

Ofcom's Notifications of Proposals

Public (national) consultation & notification of Ofcom's findings

A7.76 Ofcom is required to give interested parties an opportunity to make representations on its proposals contained in this document. That statutory obligation to consult is set out in:

- section 49(4) of the Communications Act in respect of any proposed directions, approvals or consents given under SMP services conditions; and
- sections 48(2) and 80(1) of the Communications Act in respect of any proposals on services market identifications, market power determinations and modifications to the relevant SMP services conditions, of the Communications Act in accordance with Article 6 of the Framework Directive where the proposed draft measures have a significant impact on the relevant markets.

A7.77 Ofcom is entitled, by virtue of section 80(2) of the Communications Act, to publish a single notification of its proposals as to services market identifications, market power determinations and modifications to the relevant SMP services conditions. Such a notification is published at Annex X to this document.

A7.78 To conclude the consultation process and in making its final decisions in respect of services market identifications, market power determinations and modifications to, as well as setting and revocation of, the relevant SMP services conditions, Ofcom is required to publish a notification under sections 48(1), 79(4) and 86 of the Communications Act. Again, by virtue of section 79(5) of the Communications Act, Ofcom may publish a single notification in respect of all of those matters. Subject to the outcome of our consultation Ofcom expects to publish such further notification in [date final statement]

Impact Assessment

A7.79 The analysis presented in Section 7 of this document, when read in conjunction with the rest of this document, represents an Impact Assessment ("IA"), as defined by section 7 of the Communications Act.

A7.80 Impact Assessments provide a valuable way of assessing different options for regulation and showing why the preferred option was chosen. They form part of best practice policy-making and are commonly used by other regulators. This is reflected in section 7 of the Communications Act, which means that generally we have to carry out Impact Assessments where our proposals would be likely to have a significant effect on businesses or the general public, or when there is a major change in Ofcom's activities. In accordance with section 7, in producing the Impact Assessments in this document Ofcom has had regard to its published guidance 'Better Policy Making, Ofcom's approach to Impact Assessments', issued 21 July 2005.

Annex 8

Draft legal instruments

NOTIFICATION OF PROPOSALS UNDER SECTIONS 48(2) AND 80 OF THE COMMUNICATIONS ACT 2003

Proposals for identifying markets, making market power determinations and the setting of SMP services conditions in relation to BT and KCOM under section 45 of the Communications Act 2003.

Background

1. On 28 November 2003 the Director General of Telecommunications ("the Director") published the *Fixed Narrowband Retail Services Markets explanatory statement and notification.* (the 2003 statement)

2. On 29 December 2003, Ofcom took over the functions and responsibilities under the Communications Act 2003 relating to the EC Communications directives from the Director.

3. On 19 January 2006 Ofcom published the *Retail Price Controls explanatory statement* allowing retail price controls confirmed in the 2003 statement to lapse.

4. On 12 April 2006 Ofcom published *The Replicability of BT's regulated retail buisiness services and the regulation of business retail markets statement*.

5. On [today's date] Ofcom published a consultation document *Review of the fixed narrowband services wholesale markets* consulting on proposals made in relation to fixed narrowband markets identified at the wholesale level.

Proposals

6. Ofcom hereby makes, in accordance with sections 48(2) and 80 of the Communications Act 2003 (the "Communications Act"), the following proposals for identifying markets, making market power determinations and the setting of SMP services conditions by reference to such determinations.

7. Ofcom is proposing to identify the following markets for the purpose of considering market power determinations:

(a) for the United Kingdom, except the Hull Area:

(i) Residential Fixed Narrowband Analogue Access
(ii) Business Fixed Narrowband Analogue Access
(iii) Residential Fixed Narrowband Calls
(iv) Business Fixed Narrowband Calls
(v) ISDN2 Access

(vi) ISDN 30 Access

(b) for the Hull Area:

(i) Residential Fixed Narrowband Analogue Access
(ii) Business Fixed Narrowband Analogue Access
(iii) Residential Fixed Narrowband Calls
(iv) Business Fixed Narrowband Calls
(v) ISDN2 Access
(vi) ISDN 30 Access

8. Ofcom is proposing to make market power determinations that the following persons have significant market power:

(a) in relation to each of the markets set out at paragraph 7(a)(v) and 7(a)(vi) above, BT;
(b) in relation to each of the markets set out at paragraph 7(b) above, KCom.

9. Ofcom is proposing that each of the markets set out in 7(a)(i) to 7(a)(iv) are effectively competitive and, therefore, is not proposing to determine any person as a person having significant market power in those markets.

10. Ofcom is proposing to set SMP conditions on the person referred to in paragraph 8(b) above as set out in Schedule 1 to this Notification.

11. The effect of, and Ofcom's reasons for making, the proposals to identify markets set out in paragraph 7 above and to make the market power determinations set out in paragraphs 8 and 9 above are contained in, in the case of the markets set out in:

(a) sub paragraphs 7(a)(i), 7(a)(ii), 7(a)(v), 7(a)(vi) and 8(a)(i), 8(a)(ii), 8(a)(v), 8(a)(vi) in section 5 of the consultation document accompanying this Notification;
(b) sub-paragraphs 7(a)(iii), 7(a)(iv) and 8(a)(iii), 8(a)(iv) in section 6 of the consultation document accompanying this Notification;

12. The effect of, and Ofcom's reasons for making, the proposals to set the SMP conditions set out in Schedule 1 to this Notification, and for proposing no retail SMP conditions as set out at paragraph 11 above are contained in Sections 7 and 8 of the consultation document accompanying this Notification.

13. It is proposed that the conditions set out at Annex H of the *Fixed Narrowband Retail Services Markets explanatory statement and notification* be revoked in accordance with paragraph 14 below.

14. The proposed revocations would take effect on the publication of any Notification under sections 48(1) and 79(4) of the Communications Act adopting these proposals.

15. Ofcom propose to further amend Annex 2 to *The regulatory financial reporting obligations on BT and Kingston Communications Final statement and notification* dated 22 July 2004 (as amended), by amending the table, "Part 2: Retail Markets" of Schedule 1 to the Annex by removing references to markets 18 to 24 inclusive; the amended table to read as follows:

Part 2: Retail Markets

Market identified and in which BT found to have SMP in previous Notification pursuant to section 79 of the Communications Act	Date
25. Provision of traditional interface retail leased lines up to and including a bandwidth capacity of eight megabits per second within the UK but not including the Hull Area	24.06.04

Ofcom's duties and legal tests

16. In identifying and analysing the markets referred to in paragraph 7 above, and in considering whether to make the proposals set out in this Notification, Ofcom has, in accordance with section 79 of the Communications Act, taken due account of all applicable guidelines and recommendations which have been issued or made by the European Commission in pursuance of a Community instrument, and relate to market identification and analysis or the determination of what constitutes significant market power.

17. In making all of the proposals referred to in paragraphs 7, 8 and 9 of this Notification, Ofcom has considered and acted in accordance with its general duties set out in section 3 of the Communications Act and the six Community requirements in section 4 of the Communications Act.

Making representations

18. Representations may be made to Ofcom about any of the proposals set out in this Notification and the accompanying explanatory statement by no later than **[date]**
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19. Copies of this Notification and the accompanying explanatory statement have been sent to the Secretary of State for Business, Enterprise and Regulatory Reform in accordance with section 50(1)(a) of the Communications Act, as well as the European Commission and to the regulatory authorities of every other member State in accordance with sections 50(3) and 81 of the Communications Act.

Interpretation

20. Save for the purposes of paragraph 2 of this Notification and except as otherwise defined in paragraph 21 of this Notification, words or expressions used shall have the same meaning as they have been ascribed in the Communications Act.

21. In this Notification:

(a) **"BT"** means British Telecommunications plc, whose registered company number is 1800000, and any of its subsidiaries or holding companies, or any subsidiary of such holding companies, all as defined by section 736 of the Companies Act 1985 as amended by the Companies Act 1989;

(b) **"Hull Area"** means the area defined as the 'Licensed Area' in the licence granted on 30 November 1987 by the Secretary of State under section 7 of the Telecommunications Act 1984 to Kingston upon Hull City Council and Kingston Communication (Hull) plc.

(c) **"KCOM"** means KCom Group plc, whose registered company number is 2150618, and any of its subsidiaries or holding companies, or any subsidiary of such holding companies, all as defined by section 736 of the Companies Act 1985 as amended by the Companies Act 1989;

Schedule 1

The conditions imposed on KCom under Sections 45 and 91 of the Communications Act 2003 as a result of the analysis of the markets set out in paragraph 1(a) of this Notification in which BT has been found to have significant market power

1. Conditions DA1 and DA2 shall apply to the markets set out in paragraph 7(b) of this Notification.

2. For the purpose of interpreting the conditions imposed on the Dominant Provider following a review of the markets referred to in paragraph 7(b) of this Notification the following definitions shall apply-

"Communications Act" means the Communications Act 2003;

"Dominant Provider" means KCOM Group plc, whose registered company number is 2150618, and any of its subsidiaries or holding companies, or any subsidiary of such holding companies, all as defined by section 736 of the Companies Act 1985 as amended by the Companies Act 1989;

3. Except insofar as the context otherwise requires, words or expressions shall have the meaning assigned to them and otherwise any word or expression shall have the same meaning as it has in the Communications Act.

4. The Interpretation Act 1978 shall apply as if each of the conditions were an Act of Parliament.

5. Headings and titles shall be disregarded.

Part 2: The conditions

Condition DA1 – Requirement not to unduly discriminate

DA1.1 The Dominant Provider shall not unduly discriminate against particular persons or a particular description of persons in relation to services offered.

DA1.2 Nothing done in any manner by the Dominant Provider shall be regarded as undue discrimination under this Condition if and to the extent that the Dominant Provider is required or expressly permitted to do such thing in that manner by or under any condition set under section 45 of the Communications Act which applies to the Dominant Provider.

Condition DA2 – Requirement to publish charges

DA2.1 Except in so far as Ofcom may otherwise consent in writing, the Dominant Provider shall publish charges, terms and conditions and act in the manner set out below.

DA2.2 The Dominant Provider shall publish charges, terms and conditions, including bundled charges, terms and conditions (whether or not those bundles include charges,

terms and conditions for services supplied in markets to which this Condition does not apply).
DA2.3 The Dominant Provider shall publish any amendments to the charges, terms and conditions published under paragraph DA2.2, including charges, terms and conditions for any new services, within 24 hours of the time that the amendment comes into effect.

DA2.4 Publication referred to in paragraphs DA2.2 and DA2.3 shall be effected by placing a copy of the information on any relevant website operated or controlled by the Dominant Provider.

DA2.5 The Dominant Provider shall send to Ofcom a written notice of any amendment to the charges, terms and conditions published under paragraph DA2.2 (including charges, terms and conditions for any new services) within 24 hours of the time that the amendment comes into effect and shall send a copy of the notice to any person who may reasonably request such a copy.

DA2.6 Where it would be impractical for the Dominant Provider to publish under paragraphs DA2.2, DA2.3 or DA2.5 any charge or amended charge, the Dominant Provider shall instead publish the method to be adopted for determining that charge or amended charge.

DA2.7 The Dominant Provider shall provide services at the charges, terms and conditions published under this Condition, and shall not depart therefrom either directly or indirectly.