

# Fixed Narrowband Retail Services Market

## Response to Ofcom Consultation

## 1. Introduction

COLT welcomes this opportunity to respond to Ofcom's review of fixed narrowband retail markets. Whilst broadband is the growth sector of the fixed electronic communications market, traditional voice services remain important for both business and residential customers. BT's announcement on 7th April 2009<sup>1</sup> that the pace of migration of voice products to 21CN will be "at a slower pace" means that traditional platforms for delivering voice services are likely to remain important for the foreseeable future and so it remains important that this sector is properly regulated.

COLT's primary concern is the market for business customers where BT remains a significant player despite many years of facing competition from suppliers such as COLT. We have carefully studied the analysis Ofcom puts forward for finding no firm has Significant Market Power (SMP) in the narrowband retail markets and find this analysis unconvincing. BT currently has a market share above the level at which SMP can be presumed in all of the markets reviewed. A simple extrapolation of the market share trend reported by Ofcom indicates that this position is likely to continue throughout the period covered by a market review and that, even for those markets where BT's share is likely to fall below the 50% threshold, in no market is it likely to fall below the 40% threshold at which a lack of SMP is normally presumed.

In the light of this, we believe the onus falls on Ofcom to demonstrate that the other criteria it considers unequivocally point to a lack of SMP. Below we give some of reasons why we think Ofcom's analysis does not prove a lack of SMP:

- In most markets analysed by Ofcom, BT is able to retain a price premium evidenced by its share of revenue being greater than its share of volume;
- Ofcom relies heavily on survey data which asks customers how they are likely to behave in the event of a price rise. Such surveys often overstate behaviour and are not supported by the little empirical evidence reported in the consultation document. Further, the survey results do not indicate the time period over which customers might switch supplier; and
- Ofcom's analysis is often one-sided, explaining why it believes BT's ability to charge a price premium does not indicate the presence of SMP, but not exploring why it might indicate the presence of SMP.

In the light of this we think that it is premature to find no SMP and therefore remove regulation from retail markets. In the event that Ofcom is wrong in its assessment, there is a serious danger that BT could strengthen its market position through unfair means which will ultimately harm competition and customers. The current economic climate makes it essential that Ofcom does not take such a risk. The future will be dependent on a strong telecoms infrastructure able to meet the needs of business customers and residential consumers. All empirical evidence points to the importance of a competitive market in delivering the needs of customers. Ofcom should not at this juncture take a significant risk with the future competitiveness of the telecoms sector.

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<sup>1</sup> "21CN - Strategic Priorities 2009/10"

## 2. Ofcom's Consultation Questions

We set out below our responses to the specific questions raised by Ofcom in the consultation.

*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?*

We agree with Ofcom on the market determinations for the UK excluding Hull. We make no comment on market determinations in Hull.

*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.*

We are not convinced by Ofcom's analysis that BT does not have SMP in this market. In particular we do not accept that a firm with a 66% market share of lines and a 63% market share of revenues does not have SMP.

Ofcom's principal argument for declaring that BT does not have SMP in the market is that its market share is likely to fall over the period of the review, largely due to low barriers to entry as a result of both Local Loop Unbundling (LLU) and Wholesale Line Rental (WLR).

There is no hard and fast rule for a market share at which SMP is presumed. However, as far back as 1991, the European Court stated that a share of 50% is sufficient to presume dominance<sup>2</sup> in a case that still relevant today and referred to by the Office of Fair Trading (OFT) in its Guidelines on the Assessment of Market Power. The OFT also sets a benchmark of 40% market share at which it is unlikely that an individual undertaking will be individually dominant. BT's shares of 66% and 63% are comfortably above that level.

We have used the trend data referred to in para. 5.24 of the consultation document to forecast when BT's market share might fall below the 50% and 40% thresholds. Making an assumption that the decline in BT's market share continues at the current rate we predict it will be 2013 before BT's share falls below 50% and 2016 before it falls below the 40% threshold<sup>3</sup>. Both these dates are outside the expected time period for this market review.

COLT believes Local Loop Unbundling is well advanced in the UK. With BT's recently stated changes to deployment of some 21CN voice products and services and its intention to continue using the older TDM voice network, we believe BT's market share will not fall as quickly as predicted and that rigorous regulation is still required.

The OFT Guidelines also state that market power is more likely to exist when competitors have low market shares. Table 5.1 in the consultation document shows that the next nearest competitor has an 18% share of lines and 17% share of revenue. In both cases, Virgin's share is less than 30% of BT's share. According to para. 5.38 there are 12 significant

<sup>2</sup> Case C62/86 AKZO Chemie BV v Commission [1991] ECR I-3359.

<sup>3</sup> We have calculated the coefficient of BT's market shares for lines and revenue as  $\text{Share Lines} = 75.24 - 0.03714\text{Years}$  and  $\text{Share Revenue} = 72.36 - 0.03571\text{Year}$ .

providers using WLR, but these providers have 12% market share between them: an average of 1% per provider. We regard this as evidence that other operators have low market shares, further undermining Ofcom's analysis that no firm has SMP.

The market share evidence therefore suggests that BT should be presumed to have market power.

Other evidence presented in the consultation document also points to BT continuing to have SMP. For example, Table 5.5 shows the relative prices of BT and its competitors. The table shows BT's price to be amongst the cheapest which might suggest a lack of market power. However, Footnote 41 points out that BT's price will rise by £1.00 (a little under 10%) per month from 1<sup>st</sup> April 2009 making BT the most expensive in the group. We have searched the websites of the other operators listed and have found they have not raised their prices in line with BT.

According to Ofcom's research in para. 5.51, such a rise would lead to 22% of customers switching supplier. However, this estimate is based on what survey respondents *state* they will do and not on analysis of empirical data showing how consumers *actually* respond to price rises. Further, the survey data provides no indication as to the timescale over which customers state they would move to another supplier.

The ability of BT to raise prices by 10% and the poor evidence of likely consumer response to such a price rise, strongly suggest that it is not possible to conclude that BT does not have SMP.

*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.*

For similar reasons to those set out above, we also do not find it credible that BT does not have SMP in the market for business lines.

BT's market share is again comfortably above the 50% and 40% thresholds referred to by the OFT. Although it is likely that BT's market share will fall below 40% earlier than for residential lines (2012 for lines and 2014 for revenues) BT's high market share still indicates that it has a strong position in the market.

The difference in market shares for lines and revenues also indicates the presence of market power. BT's share of 65% of revenue against 57% for lines indicates that its average revenue per line is 14% greater than the overall market price<sup>4</sup>. We have calculated that the premium BT can charge over the market has increased from 6% in 2003 to 15% in 2008. The ability of BT to maintain a significant price premium is reflected in Figure 5.18 of the consultation document. BT's ability to maintain this price differential without losing market share indicates the persistence of market power.

Given the level of doubt concerning BT's market position, we do not agree with Ofcom's conclusions regarding the lack of SMP in the market.

<sup>4</sup> Calculated by dividing its market share of revenues by its market share of lines.

*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.*

We agree that BT has SMP in the market for ISDN2 circuits, for the four reasons stated in Ofcom's consultation document:

- i) BT's market share of 73% (Table 5.22);
- ii) Remaining barriers to entry (para 5.149 – 5.152);
- iii) The small size of BT's competitors (para 5.152)
- iv) Increasing prices and an increased margin over wholesale costs (Figure 5.25)

*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.*

We agree with Ofcom that BT has SMP in the market for ISDN30 lines for the reasons explained by Ofcom in para. 5.207.

*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*

We do not agree with Ofcom's analysis of BT's market power in the residential calls market. The analysis is superficial and is based on survey data regarding consumer behaviour which is likely to overstate consumers' willingness to switch away from a supplier in the event of a price rise. Our specific concerns are set out below.

- i) Table 6.1 in the consultation document shows BT's market share of volumes and revenues over time. We calculate that between 2003 and 2005, BT's average prices were below the average price for the market as a whole by between 3% and 5%. For this reason BT's share of revenue was less than its share of minutes. Since 2006, however, it has been able to charge a premium over the market price. In the third quarter of 2008 that premium amounted to 10.6%. That BT is able to charge a premium, despite a falling market share counters the assumption that it does not have market power.
- ii) In para. 6.23 – 6.28 Ofcom discuss sensitivity to price changes. This analysis is based entirely on survey data where customers were asked how they would respond to a price change. Such surveys are always likely to overstate customers' willingness to switch/reduce calls. It would be better for Ofcom to use statistically valid research data of consumer behaviour in response to a price change.
- iii)
- iv) Table 6.1 shows that BT lost 17% market share when its prices were below the market average but only 7% since its prices have moved above average. This does not support the results of the survey and calls into question Ofcom's reliance on such data to assess market power.

In 6.25 Ofcom states that “BT customers appear slightly more price sensitive than those of their rivals.” This is based on survey evidence that suggests that 23% of BT customers would switch in response to a 10% price rise compared with 20% for non BT customers. We have two problems with this statement. First, without seeing the raw data underlying these numbers we cannot tell whether the difference between the two reported percentages is significantly different to zero. Secondly, the data in Table 6.1 appears to contradict this finding showing that BT’s customers are prepared to pay a premium over the market average price.

- v) Figure 6.3 shows BT’s gross margins for residential calls over the period 2003/04 to 2007/08. Ofcom relies on a downward trend over the period resulting in the gross margin at the end of the period being 20% lower than at the beginning. However, Ofcom makes no comment on the fact that there has been an upturn in gross margins in the final year. It may be that the increase in 2007/08 is a “one-off” or it may be a result of BT’s ability profitably to raise its prices above the market level.
- vi) Finally, Figure 6.4 shows average revenues per minute for BT, Virgin and Others. Commenting on the fact that BT’s prices have risen in comparison to the other (although all have fallen in real terms), Ofcom says (para 6.33) “...we do not think that the increase in RPM since 2006 necessarily reflect (sic) SMP, there are a number of other possible explanations.” Ofcom then goes on to discuss the other possible explanation, but does not discuss SMP itself as an explanation of BT’s ability to raise prices above the market level.

Overall, therefore, we find that the analysis of SMP in the residential calls market is not robust enough to come to a firm conclusion that no firm has SMP in the market. Ofcom should undertake a far more rigorous analysis of BT’s potential market power before it withdraws regulation from this market. COLT would be extremely concerned at any attempt to move regulation on the basis of Ofcoms current analyses.

*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.*

For the same reasons as set out above in response to question 6.1, we find Ofcom’s analysis of SMP in the business call market lacks sufficient rigour to determine a lack of SMP.

- i) BT is able to sustain a price premium of 19% over the market average. This premium has been fairly constant over the period for which data are presented in Figure 6.7. The ability to command such a premium for an undifferentiated product should be taken as evidence of SMP.
- ii) Little quantitative evidence of switching behaviour is presented: only a single number from a survey of SMEs.
- iii) Gross margin data are not presented so we cannot tell from the consultation document whether BT’s margins on business calls are increasing.



- iv) Ofcom's discussion on the data in Figure 6.10 again covers why BT might not have SMP but does not discuss the more likely explanation that BT's ability to charge a higher price than its competitors is evidence of SMP.

We believe that for Ofcom to take the very significant step of removing *ex ante* regulation from BT requires a more thorough and meticulous examination of the market situation.

*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?*

Our answers to questions 6.1 and 6.3 set out why we think that Ofcom has not been rigorous enough in its analysis of market power and has therefore not proved the lack of such market power. Although we have deliberately not taken the view that BT definitely has SMP, in answer to this question we discuss the potential impact if Ofcom is wrong in its assessment of SMP.

We believe that Ofcom's analysis of the expected benefits of deregulation is optimistic. For example, Ofcom's assertion in para 7.14 that "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." A quick glance back at figures 6.4 and 6.10 shows that BT has been able to maintain a price premium above its competition even after the end of Retail Price Controls. We do not understand why removal of all regulation should result in BT offering lower prices. Ofcom's assertion therefore is not supported by any empirical evidence.

However, our principal concern follows from our argument in answers to the preceding questions that Ofcom has not conclusively proved the lack of SMP in the market. Removal of regulation from a firm which in fact has SMP would mean that the market would have to rely on competition law to redress any abuse of dominance in the market. As is well known, pursuit of a competition law case through the courts is time consuming and lengthy. Thus if Ofcom is wrong in its assessment and BT still has SMP, it would be in a position to reassert its dominant position to the detriment of competition and customers.

Given the importance of electronic communications to business customers, and the proven benefits of competition in improving communications services, we regard the proposal to withdraw regulation as potentially damaging to the interests of consumers, in particular business customers. Further, in the light of the current economic climate and the necessity of effective communications to support businesses as they compete, the proposal to withdraw regulation may have long term negative effects on the UK.

*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?*

Although BT has been able to raise prices and margins on ISDN2 and ISDN30, COLT would be concerned that the removal of all retail regulation could allow BT to effect an anti-competitive margin squeeze by reducing its retail prices whilst maintaining wholesale prices. We therefore prefer to maintain the existing obligations, or at least the continued obligation of

Price Publication which allows competitors to monitor, at least *prima facie*, whether a margin squeeze is taking place.

*Question 8.1 Do you consider that our proposed remedies meet the tests set out under the Communications Act?*

In the light of our comments above, we do not consider that the 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?*

Ofcom has developed a reputation in the UK and throughout Europe for its thorough and rigorous market analyses and for its objectivity. Unfortunately this consultation does not live up to the high standards traditionally set by Ofcom. The analysis of market power is superficial and apparently designed to tell the story Ofcom wants telling rather than presenting the thorough and objective analysis of markets we have come to expect from Ofcom. We are left unconvinced that there is no SMP in the market and do not believe that Ofcom has proved the case sufficiently robustly for all obligations to be removed.