<u>NON-CONFIDENTIAL VERSION</u>

Ofcom Narrowband Market Reviews 2009

Response by TalkTalk Group

June 2009

Introduction

TalkTalk Group ("**TTG**") welcomes the opportunity to comment on the proposals that Ofcom has put forward as part of its narrowband market reviews (including retail markets, wholesale markets and the BT network charge controls).

There have been many developments in these markets since the last market review in 2003. We agree that it is important that the markets are reviewed again now to establish whether the SMP designations remain relevant and that the SMP remedies remain necessary and proportionate. Needless to say, it is also necessary that Ofcom reviews the network charge controls on BT which are in any event due to expire in September 2009.

Our overall impression is that although Ofcom's analysis is thorough, we are concerned that it is also heavily coloured by a strong and unjustifiable ambition to deregulate BT in these markets whatever the evidence and/or other circumstances. In particular we believe that the proposal to remove all SMP regulation from the retail markets lacks objective and evidential support and that the network charge control proposals in the wholesale markets are unlikely to give BT the right incentives to migrate swiftly to using more modern IP network technology. Ofcom's proposals will undoubtedly also give BT more commercial muscle which in turn risks giving it undue influence in these markets.

In the following we address respectively the proposals for the retail market, wholesale market and the network charge controls. We are supportive of UKCTA's response to these consultations, however, if there is a conflict between UKCTA's position and our views expressed below, the latter should (naturally) take precedence.

1. Retail narrowband

TTG is very concerned about Ofcom's proposals to remove all SMP obligations on BT in the retail business and residential markets for fixed narrowband telephone lines and calls. We do not believe that the proposals are based on a sufficiently robust analysis of the likely state and development of competitive conditions in narrowband retail markets. We believe Ofcom harbours an overly optimistic view of the impact competitors might have on BT's market position over the next 4-5 years.

Undoubtedly, Ofcom's competition policy for fixed narrowband retail markets has been successful to some degree in ensuring sustainable market entry by strong players who have been able to challenge BT's legacy dominance. The introductions of CPS, WLR and LLU/MPF have all contributed to the gradual erosion of BT's market influence in the last 7-8 years. We do not, however, believe that the fixed narrowband retail markets have yet reached a stage where they can be said to be effectively competitive in the sense that BT no longer holds significant market power since BT still holds twice the market share of all other operators taken together.

The wholesale remedies have clearly reduced the barriers to entry since the last review in 2003 but it is also important to bear in mind that they have really only taken hold during this period. In other words, the signs of increasing competition are very young when compared to the 25-year period since liberalisation of UK telecommunications markets began with the privatisation of BT. With this timeframe in mind, it is premature and wrong to suggest that regulation is now already working so well that SMP remedies can be abolished.

In terms of impact on BT's market position to date, we would suggest that competition still has some way to go. Indeed, BT's market share of the relevant markets remains extremely high. Notably in the narrowband access markets, BT retains a market share of 66% for residential and 57% for business. In competition law terms, these market shares are still significantly above the thresholds set in case law where a firm should be considered to be in a dominant position.

Although the market review process needs to be forward-looking and, as such, needs to predict as far as possible what developments will take place over the next 4-5 years, we believe Ofcom is taking one step too far and too quickly. We do not believe there is enough reliable evidence present to support Ofcom's suggestion that competition will deliver a substantial reduction in BT market share in the next few years to the degree to which they would lose SMP. Rather we would suggest that it is far more likely that BT will maintain a strong market position over the foreseeable future and certainly over the period covered by the current market review.

BT's extremely high market share aside, we believe that there remains a significant amount of work to be done with regard to relevant wholesale products and switching processes to make sure that they can provide effective competitive constraints on BT's retail pricing and other activities. More specifically, we believe that the following matters (unless addressed) combined with its high existing market share point to SMP for BT:

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- NGN wholesale access: Ofcom needs to ensure that BT offers a "better" wholesale line rental product as part of its 21CN product development programme.

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- Single migration process: We believe that Ofcom must reach a conclusion in its single migration programme sooner rather than later to avoid prolong the debate and uncertainty among providers. Ofcom has already made pronounced statements in support of a gaining provider led switching process. We believe that it would be inappropriate to remove the SMP designation on BT without first making clear that a new single switching process must be gaining-provider led (whilst being robust enough to allay any concerns Ofcom may have around mis-selling).

- Bundling: With regard to residential markets, we are particularly concerned that deregulation would give BT an unwarranted ability to leverage its dominant market position in fixed narrowband telephony into competitive retail markets like broadband. Ofcom recognises that bundling by BT is a specific possibility as a result of deregulation. In fact TTG notes that BT already is launching bundling propositions into the market evidently in anticipation of Ofcom confirming its proposals later on. Whilst we recognise that bundling is becoming an increasingly common feature in communications markets, it is not the case that BT has so far suffered commercially by not offering such propositions. Indeed, by way of example, BT commands an impressive market share in residential broadband where it is the largest provider. And, of course, it remains by far the largest fixed telephony provider in the country. The concern is that by bundling fixed telephony and broadband, BT will be able to exploit the existing strong inertia among fixed telephony customers to switch between providers. In effect, TTG believes that BT would be able to use bundling as yet another measure to prevent or certainly slow down the positive effect of competition. It is a very strong argument as to why Ofcom should rethink its proposals to deregulate BT.

The shortcomings identified above raise barriers to entry into and competition within the relevant retail markets and therefore need to be addressed prior to deregulation. We are very concerned that Ofcom would be taking a considerable risk by removing retail regulation on BT at this point in time when sustainable competition is slowly taking foothold following Ofcom's efforts to introduce effective wholesale products. BT remains in a unique position to exploit its market position to the detriment of consumers in ways no other operator is able to do. TTG is seeking reassurances from Ofcom that its proposals are not the result of a pre-determined agenda to deregulate BT whatever the circumstances.

2. Wholesale narrowband

Ofcom proposes that BT retains SMP in the markets for exchange lines, call origination and call termination in the UK (outside Hull). Ofcom also proposes that all other providers should be considered to hold SMP in fixed geographic call termination on their own respective networks in the UK. With regard to exchange lines, these proposals represent very little change compared to the current regulatory framework. With regard to call conveyance, however, the proposals entail a substantial amount of deregulation of the tandem layer in BT's network.

We would make the following observations with regard to Ofcom's proposals.

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Requirement for NGN wholesale access product

The arrival of next generation networks ("**NGN**") promises the delivery of more efficient and feature-rich products. We believe SMP providers should be required to wholesale versions of these products. In the case of BT and this market review, we believe that BT should be required to provide a new wholesale access product that exploits the advantages brought by NGNs (e.g. increased service control by the wholesale customer). This market review is an ideal opportunity for Ofcom to impose such a requirement on BT/Openreach to make the SMP conditions relevant to current and expected technological developments.

Local to tandem conveyance

Ofcom is proposing to remove the SMP designation on BT in the market for local-tandem conveyance ("**LTC**") and transit.

We understand Ofcom's reasoning that increased DLE interconnection has reduced overall demand for BT's LTC services over the last few years. However, we believe that Ofcom is underestimating the ability of BT to adopt distorting prices in relation to specific interconnect services like Average Porting Conveyance Charge ("**APCC**").

We would urge Ofcom to disclose BT's total number of minutes of LTC including APCC to obtain a clearer picture of BT's position in this market. Ofcom's consultation document does not appear to include this vital piece of market information. We would argue that APCC minutes for LTC should be included in the total number of minutes of external supply to gauge an accurate picture of BT's true market position.

With regard to the APCC, we disagree with Ofcom's analysis that BT would be constrained by the competitive supply of LTC. When a porting recipient provider receives a call from BT's network, the provider currently has no ability to avoid paying the LTC (since BT does not hand over this traffic on DLE routes). As the donor provider, BT is complete control over how this traffic is routed and hence would have both the ability and incentive to increase the APCC.

Precisely because the way in which porting works in the UK, the donor provider does not face any competitive constraint in setting its APCC. Nor does the recipient provider have any buyer power in relation to the donor provider because it cannot avoid the traffic to ported numbers being conveyed over the donor provider's network (or indeed how the traffic is routed over their network). In fact, it is quite reasonable to argue that the conveyance of traffic to ported numbers across the donor provider's network is a distinct economic market in which each donor provider enjoys a monopoly position (and indeed SMP).

It is therefore clearly not sufficient to rely, as Ofcom does, on the general cost-orientation obligations in General Condition 18. If Ofcom deregulates this market, the visibility of how the APCC is built up will disappear because BT, in theory, will not have to publish the LTC element of the charge. Ofcom must address this issue if it confirms its position to remove the SMP designation for LTC as part of the APCC. We would argue that there are ways of creating effective competitive pressure on the donor provider. For instance, if the originating operator (rather than the recipient provider) was liable to pay the APCC and also had sufficient knowledge that the number was ported it would be able to take a conscious decision to route the traffic directly to the recipient provider (thereby avoid paying the APCC). By the same token this would also introduce an incentive on the donor provider to route ported traffic efficiently and competitively across its own network (if it was asked to do so by the originating operator). That incentive does not exist today.

3. Network charge controls

Ofcom's method of calculating the proposed network charge controls is carried out against the background of the likely migration of voice telephony traffic to next generation networks ("**NGN**") during the life of the next control. Together with a "hypothetical ongoing network" cost model, Ofcom is proposing, for the first time since network charge controls were imposed on BT, that BT's regulated interconnection charges should actually be allowed to increase above the rate of inflation for the next four years. Taking the highest level of X-values proposed, the proposed network charge controls would suggest, for instance, that BT would be allowed to increase its call termination and origination charges by as much as 50% over the course of this period.

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<u>Alternative network operators' termination rates</u>

By using a hypothetical PSTN cost model as a basis for the proposed network charge controls, Ofcom intends to ensure that the model copes with "*uncertain costs and timing associated with technology change*" (section 1.17 of the consultation document). Whilst we do not necessarily disagree with this approach, we would make the following observations about the implications of what Ofcom is proposing on the termination rates offered by alternative network operators:

(i) Ofcom is sending out a strong signal that it does not consider it appropriate to introduce a charging regime that puts any particular pressure on BT to migrate its voice telephony traffic to NGN. Indeed, Ofcom seems to be of the misconception that setting a price higher than the likely cost increases the incentive for cost minimisation. This is wrong. Any cost minimisation incentive arises from the potential to reduce cost irrespective of whether the price is higher or lower than existing cost. Ofcom could have adopted a much firmer approach and proposed charge controls that were based on BT migrating to NGN sooner rather than later in order to be able to realise any margin on call termination or origination.

(ii) Ofcom is deliberately and indeed explicitly ignoring the Commission's Recommendation on termination rates[1], which provides that these should be set using NGN costs as the appropriate cost model. By ignoring this central part of the Recommendation, it is fair to assume that Ofcom has no intention of following the Recommendation at all when it comes to setting termination rates for fixed telephony networks.

(iii) In the wholesale narrowband review consultation, Ofcom states with regard termination rates levied by alternative network operators that it:

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[1] http://ec.europa.eu/information_society/policy/ecomm/doc/implementation_enforcement/article_7/recom_term_rates_en.pdf

> *"continues to be of the view that "fair and reasonable" should include the principle of reciprocity, take into account differences in networks, and that BT's costs are likely to be close to those of an efficient network. As BT and other terminating CPs progress in their migration from legacy networks to NGNs, the question of what constitutes an efficient cost base and how differences in networks should be taken into account under various migration scenarios will need to be addressed."* (Section 12.84 of consultation document)

Ofcom goes on to state:

> *"In the past, Industry has used the Reciprocity Agreement as the mechanism for setting termination charges. The current Reciprocity Agreement is due for renegotiation. We would expect that this negotiation will address the migration between legacy networks and NGNs in such a way that CPs who migrate at different speeds are not unduly penalised. We continue to be of the view that it is appropriate for industry to establish this agreement rather than Ofcom imposing it as a regulatory requirement."* (Section 12.85 of consultation document)

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4. Conclusion

We believe that:

- With regard to retail markets, Ofcom's proposals represent premature and unjustified deregulation of BT who commands a very high market share and benefits from various anomalies in the market, including lack of competitive constraint by LLU MPF, ability to tie customers into rolling contracts, lack of an adequate single migration process and, if Ofcom's proposals are implemented, an ability to extend a dominant position in voice telephony into broadband through bundling practices.

- With regard to wholesale markets, Ofcom's proposals overemphasise the competitive constraints offered by MPF, need to include a requirement on BT to offer an NGN wholesale access product, and underestimates BT's ability to increase the APCC if LTC is deregulated.

- With regard to the network charge controls, Ofcom's proposals need to be refined and adjusted with regard to several cost items (including pension deficit contributions, starting costs, efficiency gains, cost of capital and inflation) and need to be clarified what they (in combination with Ofcom's statements in the narrowband wholesale market review) mean for the termination rates charged by NGN alternative network operators.

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