Ofcom: Review of Wholesale Broadband Access Markets
Second Consultation

27th September 2010

1 Introduction

In its second consultation on markets definitions, Ofcom has made a number of comments regarding SPC Network's annex to BT's response to Ofcom's first consultation. We have been asked by BT to respond to the issues raised by Ofcom. In our annex to the first consultation we concluded that wholesale broadband market conditions were such that only one break in the geographic market exists: between exchanges where there is BT only or BT plus only one other "Tier A"[1] operator and where there is BT and two or more Tier A operators. The definition of Market 2 proposed by Ofcom in the first consultation would mean that this market would be likely to have some exchanges where conditions were competitive and some where there is less competition.

Ofcom has made the following points concerning our analysis:

i) The HHI[2] figures we used show the markets to be above the threshold at which competition authorities regard a market as concentrated;

ii) The churn data is unreliable because we have measured churn at the retail rather than the wholesale level;

iii) The academic work referred to does not specifically address telecoms markets and anyway shows ambiguous results;

iv) LLU operators' pricing strategy will be reflected in market shares in Market 2, such that if BT is able to maintain a strong share in this market the impact of common on-net pricing is not as strong;

v) The acquisition of Tiscali by TalkTalk Group (TTG) reduces the number of Principal Operators (POs) and so could result in exchanges moving from Market 3 to Market 2.

In the remainder of this short paper, we respond to the issues raised above.

[1] In our original response we referred to BT, Sky, TTG and Virgin Media as "Tier A" operators as between them they have some 85% market share.
[2] Herfindahl-Hirschmann Index – a measure of market concentration calculated by summing the squares of the market shares of all firms in the market. The higher the HHI, the more concentrated (less competitive) the market.

2 Response to Ofcom Comments

2.1 Market Concentration

In paragraphs 3.30 and 3.31 of the second consultation, Ofcom makes the point that the HHI we report for Markets 2 and 3 are above the level the European Commission and US Department of Justice (DOJ) consider as indicative of a concentrated market in their merger guidelines (2,000 and 1,800 respectively).

The actual level of concentration at a single point in time was not the point of our comments with regard to the HHI. Rather we wanted to demonstrate two points. First, the mean level of concentration in Market 2 in March 2010 was slightly below (less concentrated), than the mean level of HHI in Market 3 in January 2007. This means that, on average, Market 2 today is slightly more competitive than Market 3 was when it was first found to be free of SMP. Secondly, whereas the mean HHI in Market 1 has remained around 9,900, the mean market share in Market 2 has fallen from 8,300 to 5,300. Its competitive conditions have changed substantially, compared with Market 1 which remains almost monopolistic at the wholesale level. There is a clear trend towards decreasing concentration in Market 2 which is not present in Market 1. On this basis, we suggested that the competitive conditions in Market 2 are now closer to those in Market 3 than Market 1.

Ofcom's comments about the HHI thresholds used by the European Commission and the DOJ tell only half the story. The European Commission merger guidelines[3] refer not only to the level of HHI, but also to the "delta", or change, in HHI as a result of a merger. Concerns about a merger are raised if the post merger HHI is between 1,000 and 2,000 with a delta above 250 or a post merger HHI above 2,000 with a delta of 150 or more. Even when mergers are well above these thresholds, they can be allowed. A recent and relevant example is the merger between Orange and T-Mobile in the UK where the post merger HHI rose by approx. 940 points from 2,267 to 3,203[4].

Neither the European Commission nor the DOJ automatically blocks a merger if the HHI is above 2,000 or if the delta meets the thresholds above, rather these levels are only referred to as raising a "cause for concern".

2.2 Churn

In our annex to the BT response to the first consultation, we showed churn rates in the three markets over the period Q3 2008 – Q3 2009. The churn rates in Markets 1, 2 and 3 were ✂ respectively. Ofcom questions this analysis on the basis that we have used churn at the retail level whereas the review is of the wholesale market and so churn rates may be different.

Given that the four largest retail broadband providers (BT, Sky, TTG and Virgin Media) have a combined market share of 85%[5] and are based either on their own network or Local Loop Unbundling (LLU), we do not consider it material to the argument that we used retail churn rates rather than wholesale. Sky, TTG and Virgin Media are present in the vast majority of Market 2 and 3 exchanges and it can therefore be reasonably assumed that a retail customer

---

[3] European Commission (2004) *Guidelines on the assessment of horizontal mergers under the Council Regulation on the control of concentrations between undertakings* 5th February 2004. Paragraph 20

[4] Author's calculation based on market share data from Informa, June 2010.

[5] As pointed out in our Annex to the first consultation response. Based on Informa World Broadband Information Service data.

switching from BT to, say, TTG, results in churn at the wholesale level as the customer is moved onto TTG's LLU network. Given the almost ubiquitous presence of these three competitors to BT in Markets 2 & 3 we make the reasonably assumption that at least 85% of all customer churn takes place at the wholesale level. Even if all the other 15% was at the retail level, which is unlikely given the presence of O2 for example, the wholesale churn rates in Markets 2 and 3 would be ✂ and ✂respectively which means these two markets are still closer to each other than they are to Market 1, where the churn rate was.✂

2.3 Academic Work

Ofcom points out that the work by Bresnahan and Reiss[6] we referred to in the original annex refers to various services markets and found that in one of these markets more competitors were needed for the full effects of competition to be felt. Ofcom dismisses the academic work by claiming that its own analysis in the first consultation is "more relevant".

We disagree. First, that the Bresnahan and Reiss article is not directly concerned with telecoms markets does not negate the general direction of our argument in the original paper that most of the competitive benefits are felt with three to four competitors and there is a diminishing impact from the addition of further competitors. As we showed in Figure 3 of our original annex, once there are two Tier A competitors to BT in an exchange area, BT's market share is on average below the 40% threshold at which SMP may be presumed.

There is much further evidence, both theoretic and empirical, that three to four competitors are sufficient in most markets, regardless of product or geography, for most competitive benefits to be felt.

> In a speech[7] to the American Bar Association, William Kolansky of the US DOJ, referred to Cournot and Bertrand models of competition. He showed the Cournot equilibrium price with few and many competitors[8]. In the chart, the price falls by 42% below the monopoly price with the presence of the first three entrants firms, but only by a further 15% with the next three entrants.
>
> An Economic Policy Note prepared for the Dutch regulator, OPTA, asked whether two competitors are enough[9]. In that note they refer to the above DOJ analysis, but also to European Commission merger practice which, they say, shows that whereas 3 to 2 mergers are normally viewed as problematic, 5 to 4 mergers are not.
>
> Prof Davies of the University of East Anglia's Centre for Competition Policy (CCP) has reviewed the Competition Commission's (CC) market analysis in the case of the acquisition of Safeway[10]. In the case nearly all the supermarket chains in the UK bid for Safeway and the CC reviewed which acquiring party would have the least effect on geographic market concentration. Prof. Davies shows that the CC allowed Morrisons to acquire Safeways (subject to the disposal of some branches) to ensure that the number of supermarkets in most geographic market remained above 3.7 on average,

[6] Bresnahan, T and Reiss, P (1991) _Entry and Competition in Concentrated Markets_ The Journal of Political Economy, Vol. 99 No. 5 (Oct. 1991) pp 977 - 1009

[7] Kolansky, W.J. (2002) *Coordinated Effects in Merger Review: from dead Frenchmen to Beautiful mids and mavericks* Speech to the American Bar Association, April 24th 2002, Washington D.C.

[8] Ibid. Fig. 6

[9] OPTA (2006) *Is two enough?* Economic Policy Note no. 6

[10] Davies, S (2003) *How many sellers do we need for effective competition?* CCR Newsletter, Issue 5 (Note that in 2003 the CCP was then called Centre for Competition and Regulation)

which Prof. Davies considered was what the CC thought would prevent coordinated action between the firms.

Clearly, supermarkets are not telecoms companies. However, the weight of theoretic and empirical evidence suggests that there is a general case that three firms are sufficient for most of the benefits of competition to be available to consumers and for there to be sufficient competition to deter coordinated action.

Secondly, Ofcom's own analysis in paragraphs 3.262 – 3.295 of its first consultation document concentrates on the mechanistic approach of how many firms are present in the exchange without any analysis of the effects on competitive outcomes or on the incentive of firms to behave in a coordinated manner, which is the subject of the research discussed above. Instead it only examines the effect of the number of firms present in an exchange area and, unsurprisingly, finds BT has a lower market share where there are more firms present in an exchange. It does not therefore provide any greater insight into how competitive conditions change in the WBA market specifically than the academic research cited above.

2.4 Pricing Behaviour

Ofcom rejects our analysis of pricing spillover by saying that BT's market share in Market 2 suggests that the impact of common on-net pricing is not strong.

Ofcom's statement apparently takes a view of competition in which consumers immediately respond to a price change by switching suppliers, whereas there are many reasons why consumers switch suppliers relatively slowly over time. Examples of factors that might cause stickiness include contract periods which include some penalty for early switching, lack of consumer awareness of a price change by a competitor and simple non-activity in the market if a consumer is not thinking about changing his or her broadband supplier. Consumer search and switch costs mean that there is always some friction and lag between the entry of a new supplier (or a change in price by a supplier from an off-net to an on-net price) and a consumer's decision to change supplier.

It can reasonably be assumed that POs have entered Market 2 exchanges later than Market 3 and that therefore there would be a lag in the effects of competition on BT's market share. The higher market share of BT in Market 2 cannot therefore be taken as evidence of different competitive conditions, especially taking a forward looking view over the next few years, but rather as evidence of later entry by WBA market players resulting in a later reduction in BT's market share.

2.5 Acquisition of Tiscali by TTG

Ofcom's final response to our annex is to discuss the effect of the acquisition of Tiscali by TTG and how this might affect market definitions. Ofcom points out that the acquisition affects the number of competitors in relevant exchange areas, even if a competitor is strengthened and that therefore exchanges may correctly be moved from Market 3 to Market 2.

Ofcom's response highlights the mechanistic approach of its geographic market definition as it simply does not take account of the relative strength of firms and how this affects competitive conditions. TTG's acquisition of Tiscali has clearly created a stronger competitor. As Table 1 in our original response shows all principal competitors in the WBA market are strong firms in their own right and TTG has the largest unbundling footprint in the highest number of exchanges. A stronger competitor is likely to be better for consumers. We can only restate that it would be a perverse outcome if, at the risk of confusing market definition and a finding of SMP, BT became regulated in an exchange where it was previously not regulated as a result of an increased market share by one of its main competitors.

3 Conclusions

Ofcom's comments on our annex to BT's response to the first consultation do not undermine the central argument in that annex that there is a clear difference in the competitive conditions between exchanges where there are BT only or plus one other Tier A operator and BT plus two or more Tier A competitors. Market 2, as defined by Ofcom in the first consultation contains exchange areas where competition conditions are heterogeneous and thus there is a real danger that regulation will be applied in some exchange areas where it cannot be justified by the competitive conditions.

Further, Ofcom's mechanistic approach to market definitions based on a simple count of competitors takes no account of competitive outcomes or of the strength of those competitors and the behaviour of consumers. Thus there is a real possibility of an exchange area moving from Market 3 to Market 2, and therefore BT being regulated in that area, as a result of merger activity by a competitive operator creating a stronger competitor to BT.

We therefore stand by our original conclusions and our proposed market definitions.