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Office of Communications (Ofcom)

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For the attention of:  
Mr Ed Richards  
Chief Executive Officer

Fax: +44-20 7981 3504

Dear Mr Richards,

**Subject: Commission decision concerning case UK/2010/1123: Wholesale broadband access market**

**Comments pursuant to Article 7(3) of Directive 2002/21/EC<sup>1</sup>**

## **I. PROCEDURE**

On 20 August 2010 the Commission registered a notification from the Office of Communications (Ofcom) concerning the review of the geographic definition of the market for wholesale broadband access<sup>2</sup> (WBA) in the UK.

The national consultation<sup>3</sup> runs in parallel with the EU consultation under Article 7 of the Framework Directive. The deadline for the EU consultation is 1 October 2010.

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<sup>1</sup> Directive 2002/21/EC of the European Parliament and of the Council of 7 March 2002 on a common regulatory framework for electronic communications networks and services (Framework Directive), OJ L 108, 24.4.2002, p. 33.

<sup>2</sup> This market corresponds to market 5 of Commission Recommendation 2007/879/EC of 17 December 2007 on relevant product and service markets within the electronic communications sector susceptible to *ex ante* regulation in accordance with Directive 2002/21/EC of the European Parliament and of the Council of 7 March 2002 on a common regulatory framework for electronic communications networks and services (Recommendation), OJ L 344, 28.12.2007, p. 65.

<sup>3</sup> In accordance with Article 6 of the Framework Directive.

On 3 September 2010 a request for information<sup>4</sup> (RFI) was sent to Ofcom and a response was received on 8 September 2010.

Pursuant to Article 7(3) of the Framework Directive, national regulatory authorities (NRAs) and the Commission may make comments on notified draft measures to the NRA concerned.

## **II. DESCRIPTION OF THE DRAFT MEASURE**

### **II.1. Background**

#### *II.1.1. First round market review*

The first review of the market for WBA was notified to and assessed by the Commission in 2003.<sup>5</sup> At the time the then national regulatory authority, the Office of Telecommunications (OfTel), segmented the WBA market into the UK area (excluding Hull) and the Hull area<sup>6</sup>. OfTel designated BT as the operator holding significant market power (SMP) in the UK (excluding Hull) and KCOM as the SMP operator in the Hull area and imposed regulatory obligations on these operators. The Commission contested the inclusion of cable-based services in the market definition based on the indirect pricing constraint exercised on DSL-based services at the retail level, concluding, however, that the exclusion of cable would not have altered the conclusions reached by OfTel.

#### *II.1.2. Second round market review*

In its second round market review (2007/2008),<sup>7</sup> Ofcom included cable-based services and LLU self-supply in the relevant market. As for the relevant geographic market, Ofcom proposed to segment the WBA market regionally, using the number of Principal Operators (POs)<sup>8</sup> present in a local exchange as the proxy for the competitive conditions in different areas. Ofcom identified eight POs<sup>9</sup> and defined the following relevant geographic markets:<sup>10</sup>

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<sup>4</sup> Pursuant to Article 5(2) of the Framework Directive.

<sup>5</sup> UK/2003/0032-0034, SG-Greffe(2004) D/200485.

<sup>6</sup> Asymmetric broadband origination and conveyance in the UK (excluding Hull) and asymmetric broadband origination in the Hull area.

<sup>7</sup> UK/2007/0733, SG-Greffe (2008) D/200640.

<sup>8</sup> Operators that provide broadband services over their own access networks (BT or Virgin Media) or have deployed LLU in more than 10% of the UK. Virgin Media was considered to be a PO in an individual exchange area only if it was able to provide services to 65% or more of delivery points.

<sup>9</sup> BT, C&W, O2, Orange, Sky, Tiscali, Talk Talk Group and Virgin Media.

<sup>10</sup> Please note that the geographic size/coverage of Markets 1, 2 and 3, as notified to the Commission in case UK/2007/0733, differs slightly from the geographic size/coverage of the markets defined in the final measure adopted by Ofcom in May 2008. In the latter, the size/coverage of the markets was as follows: (i) Market 1 – 3720 exchanges/16.4% coverage; (ii) Market 2 – 670 exchanges/13.7% coverage; (iii) Market 3 – 1197 exchanges/69.2% coverage.

Markets	Local exchanges	No. of local exchanges	Coverage (UK premises/Delivery Points)
Hull area	Where only KCOM is present	14	0.7%
Market 1	Where only BT is present	3 874	19.2%
Market 2	With 2 or 3 POs and where there are forecasted to be 4 or more POs but where the exchange serves fewer than 10 000 premises	643	15.7%
Market 3	With 4 or more POs and where there are forecasted to be 4 or more POs but where the exchange serves more than 10 000 premises	1 070	64.4%

Ofcom concluded that there was no SMP in Market 3. KCOM was found to have SMP in the Hull area and BT was found to have SMP in Markets 1 and 2. Ofcom proposed to impose regulatory obligations in Markets 1 and 2 and in the Hull area.

The Commission commented *inter alia* on the inclusion of self-supply by vertically integrated operators (LLU and cable operators) in the relevant market and reiterated that indirect constraints, where they are found to exist, are to be taken into account during the SMP assessment and not at the market definition stage. It stated moreover that a correct assessment of the strength of the indirect constraints has to be carried out. As for the definition of geographic sub-markets, the Commission maintained that geographic segmentation had to be based on a thorough analysis of *structural factors* (e.g. number of competitors present in a given exchange area, size/density of the areas in question, distribution of market shares and their development over time within individual exchange areas) and *behavioural factors* (pricing, price trends and price differentiation at retail and wholesale level, differences in supply and demand characteristics). It further stated that the definition of geographic sub-markets would also entail assessment of whether any proposed market boundaries would be sufficiently stable over time.

### II.1.3. Third round market review

In its third round market analysis conducted in 2010,<sup>11</sup> Ofcom broadly maintained the market segmentation approach<sup>12</sup>. When defining the geographic market areas with reasonably homogeneous competitive conditions, Ofcom maintained the number of POs as the proxy for the competitive conditions in different areas.<sup>13</sup> Ofcom identified seven POs<sup>14</sup> and defined four geographic markets, i.e.:

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<sup>11</sup> UK/2010/1065, SG-Greffe (2010) D/7658.

<sup>12</sup> The threshold for exchanges with fewer than 10 000 premises/delivery points was, however, removed, i.e. exchanges which are forecast to have four or more operators but have currently fewer than four are included in Market 3 irrespective of whether they serve more than 10 000 premises/delivery points.

<sup>13</sup> The threshold for 10% coverage in order for an LLU operator to be considered a PO was removed.

<sup>14</sup> Between the second and third round market reviews the number of POs was reduced from 8 to 7 due to the acquisition of Tiscali by Talk Talk.

Markets	Local Exchanges	No. of local exchanges	Coverage (UK premises/Delivery Points)
Hull area	Where only KCOM is present	14	0.7%
Market 1	Where only BT is present	3 578	14.2%
Market 2	With 2 or 3 POs	722	13.8%
Market 3	With 4 or more POs	1 287	71.3%

KCOM was found to have SMP in the Hull area and BT was found to have SMP in Markets 1 and 2. Ofcom proposed to impose regulatory obligations in Markets 1 and 2 and in the Hull area.

The Commission reiterated its comments on the inclusion of self-supply by LLU and cable operators in the relevant market on the basis of indirect constraints and on the criteria used for geographic segmentation of the wholesale broadband access market.

## II.2. The notified draft measure

### II.2.1. Developments since the first consultation

In the current notification, Ofcom is consulting the Commission on a review of the geographic definition of the WBA market in order to take into consideration the developments that have occurred since the first consultation, i.e.:

- (i) the long-term exclusive agreement between Orange and BT for the supply of wholesale broadband access services, which means that Orange exited the WBA market and will no longer provide services based on its own LLU deployments, thus no longer counting as a PO;
- (ii) updated rollout plans by the remaining POs;
- (iii) the response from the Commission to the first consultation, where the Commission reiterated that a market definition which is based primarily on the number of operators present in a local exchange is not, in itself, sufficiently detailed or robust to identify real differences in competitive conditions for the purposes of the market definition and that other factors are to be taken into account; and
- (iv) the response to the first consultation from BT aiming *inter alia* at refinement of the market definition criteria, which would lead to further deregulation. BT claims that some exchange areas classified as Market 2 have competitive conditions that are more similar to the proposed Market 3 areas and that therefore some Market 2 areas should be classified as Market 3.

### II.2.2. The exchange level service share criterion

Ofcom recognises that the level of competition in some exchanges where three POs are present may be similar to that in exchanges where four or more POs are present. Thus, while restating that overall the number of POs present remains a good indicator of competitive conditions in the WBA markets, Ofcom proposes BT's *exchange level*

*service share*<sup>15</sup> to serve as an additional proxy for assessing the competitive conditions in those exchanges where 3 POs are present<sup>16</sup>, in particular to identify those areas in which the competitive conditions can be regarded as similar to areas where four or more POs are present.

Ofcom proposes to use a 50% service share threshold<sup>17</sup>, including the impact of migration from off-net supply to on-net supply by LLU operators at unbundled exchanges<sup>18</sup>. Ofcom determines that exchanges where three POs are present or forecast to be present will be part of Market 2 if BT's service share is equal to or greater than 50% and part of Market 3 if BT's service share is less than 50%. In the reply to the RFI, Ofcom made it clear that in order to ensure regulatory certainty, exchanges will remain in the market to which they have now been allocated until the next review, irrespective of further changes in BT's service share.

Ofcom does not apply the service share criterion to local exchanges where four or more POs are present or to exchanges where two POs are present.<sup>19</sup>

As far as the evolution of service shares is concerned, Ofcom points out that between February 2008 and June 2010, there has been a general reduction in BT's service share in exchanges where three POs are present, with such reduction being swifter in local exchanges where BT's service share is below 50%. In local exchanges where four POs are present, there has also been a general shift towards a lower service share for BT, with a reduction in the number of exchanges where BT's share is above 50% and a large increase in the number of exchanges where BT's share is in the 20% and 30% range.

### *II.2.3. Additional criteria for defining the geographic markets*

Ofcom recognises the relevance of other elements such as barriers to entry, pricing and price differences. Ofcom concludes that the number of POs reflects operators' views on barriers to entry and that the effects of price and pricing differences are already accounted for when service shares are assessed and that therefore the number of POs and the exchange service shares taken together provide an effective and practical proxy for assessing the homogeneity of competitive conditions and are likely to incorporate the effects of other factors that affect competitive conditions.

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<sup>15</sup> In the reply to the RFI, Ofcom points out that the service shares are calculated at wholesale level based on exchange level LLU data, i.e. on the basis of the number of lines provided to each communications provider (CP), including BT, in each exchange, and of the delivery points served by the exchange. The wholesale service shares are then calculated as the number of lines provided to each CP over the total number of lines provided for the purpose of supporting broadband services.

<sup>16</sup> Ofcom states that service shares at exchange level were not considered in the 2008 review due to the fact that the market was in rapid evolution and service shares were not yet stable.

<sup>17</sup> Ofcom assesses whether a 40% or a 50% threshold would be more appropriate. It concludes that since BT's share is expected to decline further, especially in exchanges where three POs are present, using a higher threshold amounts to adopting a forward-looking approach and thus allowing for further reductions in BT's actual share to be taken into account.

<sup>18</sup> Where a LLU operator has unbundled a local exchange, it has a strong incentive to migrate its customers from off-net supply based on BT's WBA products to on-net supply using the local loop. Services shares are therefore adjusted to reflect the expected impact of migration following entry.

<sup>19</sup> Ofcom maintains that exchanges where four or more POs are present can be regarded as a competitively homogeneous group for the purposes of the SMP analysis and that in exchanges where two POs are present the competitive conditions are unlikely to be similar to areas where four or more POs are present.

In the reply to the RFI, Ofcom provides further data on price and pricing differences, demonstrating that the lowest and highest price paid by consumers, as well as the average retail price, varies between the defined groups of geographic markets.<sup>20</sup> Ofcom further maintains that discounts at retail level are likely to be offered in Markets 2 or 3 and that at wholesale level BT offers discounts in Market 3 exchanges only.

#### II.2.4. Revised geographic market definition

The impact of the Orange-BT agreement, the operators' updated rollout plans,<sup>21</sup> the potential migration and the introduction of the service share criterion lead to an adjustment of the market boundaries and number of exchanges within each of the markets. The following revised geographic market definition is proposed:

Markets	Local Exchanges	No. of local exchanges	Coverage (UK premises/Delivery Points)
Hull area	Where only KCOM is present	14	0.7 %
Market 1	Where only BT is present	3 388	11.7 %
Market 2	Where two POs are present or forecast and local exchanges where three POs are present or forecast but where BT's share is greater than or equal to 50 %	660	10.0 %
Market 3	With four or more POs and local exchanges where three POs are present or forecast but where BT's share is less than 50 %	1 539	77.6 %

When compared with the final decision adopted by Ofcom in May 2008 (second round analysis), the revised approach amounts to a deregulation of 349 local exchanges, which are transferred from Markets 1 or 2 to Market 3.<sup>22</sup> In the reply to the RFI, Ofcom points out that the effect of the addition of the service share criterion (when the effect of migration is excluded) is *per se* limited, leading to an increase of Market 3 by 103 exchanges (3 % of UK premises) and the reduction of Market 2 by the same amount.

Of the total number of exchanges in Markets 2 and 3, 449 exchanges (covering 9.7 % of the UK premises) are only *forecast* to have three POs. 196 of these (covering 4.9 % of UK premises) are proposed to be included in Market 3 and 253 (covering 4.8 % of UK premises) in Market 2.

<sup>20</sup> Lowest/highest prices: (i) Market 1: £15.96/ £16.05; Market 2 - £10.98/ £13.39; Market 3 - £8.38/£12.94. The average retail price difference between Market 1 and Market 2 is around £5 and between Market 2 and Market 3 around £2.50.

<sup>21</sup> Ofcom only took into consideration the firm rollout plans of the POs, although rollout beyond these firm plans may eventually occur within the review period.

<sup>22</sup> Data contained in Appendix 4 and Annex 6 to the notification. Eleven local exchanges move from Market 1 to Market 3 and 338 local exchanges move from Market 2 to Market 3. Moreover, 12 local exchanges are moved to a less competitive market (from Market 2 to 1 or from Market 3 to 2) due *inter alia* to market consolidation.

### *II.2.5. Unchanged product market definition and SMP and remedies assessments*

Ofcom supports the proposals made in the first consultation concerning product market definition. In the reply to the RFI, Ofcom points out that other than BT, there are currently two providers actively offering wholesale broadband services.<sup>23</sup> Self-supply by BT, by LLU operators and by Virgin Media is included in the market definition. Indirect constraints from cable and LLU operators are thus specifically considered at the market definition stage. On the strength of the indirect constraints, Ofcom maintains that a hypothetical price increase of the wholesale broadband access input would be passed on in full to the retail end customer.<sup>24</sup> In the reply to the RFI, Ofcom stated that should cable not have been included in the market definition, the size of Market 3 would have been reduced by a relatively small amount (2.7%). Moreover it provided data showing that Virgin Media is considered a PO essentially in exchange areas with four or more POs and that the number of exchanges where three POs are present, one of them being Virgin Media, which now belong to Market 3, is very limited ([...] exchanges/[...] % coverage).

Revisiting its previous SMP analysis, Ofcom concludes that in light of the limited effect of the revised geographic market definition, the SMP assessment contained in the first consultation remains appropriate, i.e. KCOM holds SMP in the Hull area and BT holds SMP in Markets 1 and 2. BT is now found to have on average a 98.7% market share in Market 1, a 64.7% market share in Market 2 and a 31.0% market share in Market 3. Given the appropriateness of the previous SMP analysis, Ofcom will not revisit its remedies assessment.

### **III. COMMENTS**

On the basis of the present notification and the additional information provided by Ofcom, the Commission has the following comments<sup>25</sup>:

#### **Inclusion of self-supply in the market definition on the basis of indirect constraints**

Ofcom defines the relevant product and geographic markets by taking into consideration indirect constraints stemming from the underlying retail markets. Cable- and LLU-based services are thus included in the relevant markets.

The Commission has noted in the past that competition at the retail level from vertically integrated undertakings may be such as to exert an indirect constraint on the market for wholesale access services and that, where such indirect pricing constraints are found to exist, they should be taken into account in the SMP assessment. As already underlined by the Commission in previous cases, it is

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<sup>23</sup> [...]

<sup>24</sup> Ofcom maintains that it is difficult to obtain direct evidence of changes in wholesale prices being passed on at the retail level. It points out, however, that competition at the retail level is strong and that retailers using WBA would not be able to absorb an increase in the wholesale costs. In this regard, Ofcom claims that retail broadband prices closely reflect costs and that it is therefore reasonable to expect changes in wholesale prices to be passed on at the retail level. One source of evidence is the geographic variations in retail prices, which indicate that wholesale cost differences, in particular those resulting from the use of BT's WBA product rather than LLU, are reflected in retail prices. Low margins between the retail price and the average wholesale price also suggest that an increase in wholesale costs could not be easily absorbed and would be passed on to customers.

<sup>25</sup> In accordance with Article 7(3) of the Framework Directive.

essential that the strength of the constraints posed by vertically integrated companies be correctly reflected in the assessment and the Commission has set out appropriate criteria against which the nature of such indirect substitution effects may be assessed.<sup>26</sup>

The Commission notes that Ofcom has not provided sufficient evidence that a price increase would be entirely passed on to the end-users of retail broadband access products and that competitors would not be able, at least partly, to absorb this price increase in their margins. The question whether such indirect constraints exist has thus not been satisfactorily answered by Ofcom. The Commission therefore invites Ofcom to further substantiate its findings in the final measure.

The Commission acknowledges that the current revision of the geographic market definition, namely the addition of the exchange service share criterion, has a limited impact in the geographic markets as defined in the second review and in the first consultation.<sup>27</sup> The Commission therefore recalls its previous considerations, i.e. that Ofcom takes indirect constraints into account in its market definition only for exchange areas where Ofcom considers their presence to be capable of exercising a sufficient competitive constraint. Thus, in view of this approach, even if indirect constraints were taken into account in the market power assessment rather than at the market definition stage, this would likely not have led to a significantly different outcome than the one currently proposed by Ofcom<sup>28</sup>. The Commission therefore reiterates that, since a conclusion on whether such constraints should be taken into account in the definition of the relevant market or in the SMP assessment is not relevant to the regulatory outcome, this question could be left open at present.

### **Criteria used for geographic differentiation of the WBA market**

The Commission recalls the comments made in cases UK/2007/0733 and UK/2010/1065 regarding the definition of sub-national markets for wholesale broadband access. The Commission's view that a geographic delineation which is based primarily on the number of operators present in a local exchange is not, in itself, sufficiently detailed or robust to identify real differences in competitive conditions for the purposes of the market definition, remains valid. In assessing whether conditions of competition within a geographic area are *similar* or *sufficiently homogeneous*, additional structural and behavioural evidence is necessary.

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<sup>26</sup> Explanatory Note to the Commission Recommendation on relevant product and service markets within the electronic communications sector susceptible to *ex ante* regulation in accordance with Directive 2002/21/EC of the European Parliament and of the Council on a common regulatory framework for electronic communications networks and services (C(2007) 5406), pp. 34-35. See also cases UK/2003/0032, NL/2005/0281, AT/2005/0312 and UK/2007/0733.

<sup>27</sup> In particular, the number of exchanges where three POs are present, one of them being Virgin Media, and which belong to Market 3, is minimal (30 exchanges/0.6% coverage).

<sup>28</sup> In that regard, while the number of operators and their market shares at a given exchange might have been different had cable and/or LLU not been included at the market definition stage and this could have resulted in a different geographic segmentation of the market, the constraint posed by cable and LLU in local exchange areas would nonetheless need to have been factored into the SMP analysis. Furthermore, two LLU operators are already selling wholesale services to third parties.



Relevant evidence would include information on the distribution of market shares and the evolution of shares over time. In addition, evidence of differentiated retail or wholesale pricing which might apply could help indicate different regional or local competitive pressures. It is also considered appropriate to look at the pricing of both the incumbent and alternative operators and at its evolution over time in the relevant areas.

In the 2007/2008 review, the Commission had, on the basis of the thorough information provided by Ofcom, considered that while a certain ambiguity in competitive conditions could arise at the margins of Ofcom's identified Markets 2 and 3, Ofcom's analysis rested on a sufficiently robust evidential basis across the range of exchanges in Market 3.

The Commission takes note that Ofcom's current geographic market revision aims at refining the boundaries between Markets 2 and 3 and that the addition of the exchange level service share criterion may contribute to a more precise assessment of the competitive conditions. The Commission further recognises that Ofcom has supplied information which provides insight into the similarity of competitive conditions across local exchange areas in the UK. In particular, information on market shares and their development over time within exchange areas in Markets 1, 2 and 3 seems to reveal different conditions of competition in the markets. Information on pricing also indicates that retail broadband prices vary between the defined geographic markets.

Ofcom has, however, not supplied additional structural and behavioural evidence, e.g. data on barriers to entry, or on marketing and sales strategies and service characteristics, which could further sustain the geographic market delineation. The Commission therefore invites Ofcom again to further substantiate in its final measure its aggregation of geographic units in the proposed markets in this respect.

Pursuant to Article 7(5) of the Framework Directive, Ofcom shall take the utmost account of comments of other NRAs and the Commission and may adopt the resulting draft measures and, where it does so, shall communicate them to the Commission.

The Commission's position on this particular notification is without prejudice to any position it may take *vis-à-vis* other notified draft measures.

Pursuant to Point 15 of Recommendation 2008/850/EC<sup>29</sup>, the Commission will publish this document on its website. The Commission does not consider the information contained herein to be confidential. You are invited to inform the Commission<sup>30</sup> within three working days following receipt whether you consider that, in accordance with EU and national rules on business confidentiality, this document contains confidential information which you wish to have deleted prior to such publication<sup>31</sup>. You should give

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<sup>29</sup> Commission Recommendation 2008/850/EC of 15 October 2008 on notifications, time limits and consultations provided for in Article 7 of Directive 2002/21/EC of the European Parliament and of the Council on a common regulatory framework for electronic communications networks and services, OJ L 301, 12.11.2008, p. 23.

<sup>30</sup> Your request should be sent either by email: [INFSO-COMP-ARTICLE7@ec.europa.eu](mailto:INFSO-COMP-ARTICLE7@ec.europa.eu) or by fax: +32 2 298 87 82.

<sup>31</sup> The Commission may inform the public of the result of its assessment before the end of this three-day period.

reasons for any such request.

Yours sincerely,  
For the Commission,  
Robert Madelin  
Director-General