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Dear Steve

Review of the fixed narrowband services wholesale markets

Telefónica O2 UK Ltd ("O2") welcomes the opportunity to comment on Ofcom's Wholesale Fixed Narrowband market review¹.

Summary

O2's principal interest in this area relates to local tandem conveyance (LTC)². O2 purchases various services from BT comprising of LTC, including single tandem call termination, to the value of around [x] per annum. Accordingly, any proposed amendment to the regulatory regime in this area is likely to have a significant effect on O2.

O2's is deeply concerned at Ofcom's approach on market definition, the proposed finding that BT does not have significant market power in the relevant market, and that, as a consequence, BT's LTC should not be subject to a price cap. [x]

It is, therefore, the case that LTC pricing is constrained neither by the availability of interconnection at the DLE level, nor by the availability of LTT providers. Accordingly, O2 is firmly of the view that BT retains significant market power in a market for LTC, and that LTC should continue to be subject to a price cap.

In addition, O2 is concerned about Ofcom's proposal to deregulate BT's single transit service³. O2 accepts that the possibility of direct interconnection between communication providers constrains the pricing of single transit. [x]

In our view, the current charge control should be extended for twelve months so that O2 can manage commercial discussions with BT in an extended transitional period before deregulation takes effect.

¹ Review of the fixed narrowband services wholesale markets. Consultation on the proposed markets, market power determinations and remedies. Ofcom 19 March 2009

² Section 8 of the consultation document refers.

³ Section 9 of the consultation document refers

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In the remainder of this response, we set out the cost implications and time constraints that O2 would face in either interconnecting at the DLE level, or seeking to procure LTT from another provider. We then consider the consequences of this on the issue of market definition and whether BT enjoys a position of significant market power in the relevant market. Finally, we explain why, in our view, Ofcom should continue to impose a price control on BT in respect of LTC.

O2's reliance on LTC

O2 purchases various services from BT comprising of LTC, including single tandem call termination, to the value of around [redacted] per annum. The services ensure that O2 customers are able to call BT customers and are, therefore, of great importance to O2.

Implications of interconnecting at the DLE level or switching to LTT

Ofcom states that a communications provider can choose to interconnect with BT at the DLE level, rather than at the tandem exchange⁴. Strictly speaking, that is true. However, while Ofcom appears to acknowledge that interconnection at the DLEs “may have high capital costs”⁵, it does not appear to have quantified these. Neither has Ofcom considered the length of time it would take to complete a project to migrate traffic from tandem exchanges to DLEs.

[redacted]

There would be similar concerns about switching to a LTT provider. Again, we have not had the time to undertake a formal assessment of the costs of such a project. [redacted]

In summary, migration of O2's traffic currently sent to BT's tandem exchanges, to BT's DLEs, or using LTT, would be an extremely costly and time consuming exercise. [redacted]

⁴ Paragraph 8.8 refers
⁵ Paragraph 8.44 refers



Market definition

Ofcom's preliminary view is that local tandem conveyance and local tandem transit are part of the same market and that the possibility of DLE interconnection provides an effective constraint on LTC and LTT offered by BT⁶. For reasons that should be clear from the above, O2 does not agree with this provisional assessment.

The conventional approach to market definition is to use the so called SSNIP, or hypothetical monopolist, test⁷. A relatively narrow market definition is tested against the premise of a monopolist increasing its price by a small but significant non-transitory amount. If sufficient customers are able to switch to another product within around a year, then such a price increase would not be sustainable, and the two products would be regarded as being in the same market. If not, the market is no wider than the hypothesis.

In the case of LTC, a relatively narrow market definition would be the wholesale provision by BT of LTC. As Ofcom notes, the use of LTC in relation to some services has fallen dramatically over the last few years, apparently because other communication providers have switched to interconnect at DLEs, or buy LTT from other communication providers. In O2's view, those communication providers that continue to rely on BT services which contain LTC, are likely to continue to rely on them, because they cannot easily switch to use LTT services provided by other communication providers, or interconnect at BT's DLEs. [X<] Accordingly, O2 believes that Ofcom should carry out a SSNIP test on LTC, and consider whether an increase in the price of LTC would be profitable for BT, *going forwards*. In O2's view, this analysis differs from the approach that Ofcom has taken in the consultation document, which has been to consider *past* migration from LTC to LTT and interconnection at DLEs. O2 is firmly of the view that such a price increase is highly likely to be profitable, and that the appropriate market definition is therefore relatively narrow: wholesale provision by BT of LTC, not including LTT or interconnection at DLEs.

Assessment of market power in LTC

BT is the sole supplier of LTC. Users of BT services that rely on LTC cannot switch to other services, and, given the costs involved in switching to LTT or interconnecting at BT's DLEs, there seems little prospect of alternative sources of supply.

Furthermore, there is no evidence that the purchasers of BT's services that use LTC have any countervailing buyer power. In these circumstances, O2 is strongly of the view that BT has significant market power in the services it provides that rely on BT LTC.

Absent regulation, O2 is concerned that BT would increase the price of LTC above the competitive level. Ofcom has noted that the opportunity that some communication providers have to switch to LTT or interconnection at DLEs has not constrained the pricing of LTC:

"BT appears to have made the decision that a lower uniform price was unlikely to win back significant traffic volumes given that CPs that interconnected have already incurred sunk costs"⁸

In O2's view, the logical extension of Ofcom's analysis is that, without a charge control, BT would increase the price of LTC. [X<]

In these circumstances, O2 believes that BT would increase the price of LTC, above the competitive level. The consequences of this would be to push up the cost base of O2 (and, possibly, other mobile operators in

⁶ Paragraphs 8.1 and 8.30 refer.

⁷ See, for example http://www.ofcom.gov.uk/shared_ofcom/business_leaflets/ca98_guidelines/oft403.pdf

⁸ Paragraph 8.57 refers



a similar position to O2) distorting competition in the mobile market, and between mobile and fixed services. This would clearly be against the interests of consumers.

Remedies

O2 believes that Ofcom should continue with the current regulation of LTC. In our view, such an approach would satisfy the tests set out in the Communications Act ("the Act").

Recital 27 of the Framework Directive provides that ex ante regulation should only be imposed where competition is not effective and where competition law remedies are not sufficient to address the problem. As noted above, in O2's view, BT would increase the price of LTC in the absence of regulation. It is far from clear that the Chapter 2 prohibition in the Competition Act would constrain BT.

Section 4 of the Act imposes a duty on Ofcom, in carrying out its functions, to act in accordance with the six Community requirements set out in that section. This implements Article 8 of the Framework Directive. In the context of LTC, O2 believes that Ofcom is required to consider:

- the requirement to promote competition in relation to the provision of electronic communications networks and electronic communications services;
- the requirement to take account of the desirability of Ofcom's carrying out its functions in a manner which, so far as practicable, does not favour one form of electronic communication network, electronic communication service or associated facility,
- the requirement to encourage network access and service interoperability for the purposes, inter alia, of securing efficient and sustainable competition in the markets for electronic communications networks and services, and for securing maximum benefits for customers of communications providers.

Failure to continue to regulate LTC would distort competition in the mobile market, and between mobile and fixed services. To the extent that LTC prices would increase absent regulation, it would discourage network access and service interoperability would be discouraged.

SMP conditions must also satisfy the tests set out in section 47 of the Act, namely that each condition must be:

- objectively justifiable;
- not such as to discriminate unduly against particular persons or against a particular description of persons;
- proportionate to what the condition is intended to achieve; and
- in relation to what it is intended to achieve, transparent.

O2 believes that continuation of the present regulatory regime in respect of LTC would satisfy these tests.

Single transit

O2 is concerned about Ofcom's proposal to deregulate BT's single transit service. O2 accepts that the possibility of direct interconnection between communication providers constrains the pricing of single transit. However, in practice, migration is not a quick or costless exercise; [3<].



O2 does not object to deregulation in this area, in principle, however the transition to deregulation should be managed properly. It would be irresponsible to allow BT to extract monopoly rents in the time it would take O2 to migrate traffic away from the single transit service. In our view, the current charge control should be extended for twelve months so that O2 can manage commercial discussions with BT in an extended transitional period.

Conclusion

O2 is firmly of the view that BT possesses significant market power in the wholesale market for LTC. Ofcom should continue to regulate LTC by imposing obligations on BT to provide access on non discriminatory and cost oriented terms. LTC should also continue to be subject to a price cap.

Although we do not object to the deregulation of BT's single transit service in principle, in practice, the transition to deregulation needs to be managed properly. In our view, the charge control on single transit should be extended by twelve months to achieve this.

We should be happy to meet with you to discuss this response. If you would find that helpful, please call me.

Yours sincerely

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O2's initial thoughts about migrating single tandem call termination traffic to BT's Digital Line Exchanges

O2's biggest concern is that moving to DLE interconnect will change radically its current network design, specifically:

- Route sizes. With tandem connections, O2 can aggregate routes into efficient sizes. Interconnecting at DLEs would result in the creation of multiple routes to different DLEs instead of the original single route, which is inherently inefficient;
- Transitional capacity. Migrating to a new structure would require additional transmission capacity, old and new, during the transitional period. O2 would need additional MSC/MGW ports to do this;
- To implement a DLE network O2 would have to review the case for far end handover against the current near-end handover. This may require O2 to invest further in its core network to carry additional transiting traffic between sites;
- Change to code support and translator capacity. Currently O2 identifies geographic traffic down to 0sabc level (eg 01473), except for London bound traffic. DLEs have variable lengths, therefore O2 would need to make additional investment in its code support/translator capacity;
- The total number of routes would increase by several hundred percent. O2 would face additional build and maintenance costs;
- BT informs O2 about the status of its network via the Element Base Charging database and the NIPP. If O2 moves to a DLE network, it would need to spend more resources in monitoring its network, to ensure that it is kept aligned with BT's;
- BT 21CN network. O2's investment in moving to a DLE network might require re-work within a short period depending on the timescales of BT's migration to its 21CN, this rework would be an additional cost to O2;
- As with WAT tandem interconnect, DLE points of interconnect would be restrictive in the codes O2 could send them. This means that O2's network translator would have to be more complex to ensure that only codes that can route correctly on the DLE are sent to it, otherwise they would fail;
- DLE migration may also mean, after review, that we need to migrate our routing decisions, due to an increase in complexity, to an IN solution, at additional cost.

Estimated timescales: Anything between two and six years.

Estimated costs: Several millions of pounds

In summary, O2's initial thinking is that the move to a DLE network would require a very major upheaval to the O2 network. In addition, there would be ongoing costs for design, planning, build and maintenance. The timescales required for these changes are likely to conflict with BT's migration to its 21CN network, which would render O2's substantial investment obsolete. Without a full analysis, including changes to O2's and BT's network architecture, it is impossible properly to estimate the full costs and timescales.