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**By email:** david.clarkson@ofcom.org.uk

Dear David

**Review of the wholesale broadband access markets 2006/07: Identification of relevant markets, assessment of market power and proposed remedies**

THUS is please to respond to the above consultation dated 21 November 2006. We set out below our responses to the specific questions posed by Ofcom.

*Question 1: Do respondents consider that the regulatory remedies put in place in the 2003/04 market review were effective in counterbalancing BT's and Kingston's SMP in the relevant markets?*

No. It was a mistake to restrict the regulatory remedies to DataStream and leave IPStream unregulated. This has had a number of unfortunate consequences, such as:

- the inability of resellers to obtain appropriate business-grade variants of IPStream (which might otherwise have been subject to an obligation to provide on reasonable request);
- the necessity for Ofcom to impose additional constraints on IPStream by means of the Undertakings and other 'voluntary commitments' which lack the transparency and enforceability of ex ante obligations;
- the ability of BT to discriminate in favour of its retail arms in provision of IPStream products (notably in certain parts of Scotland where BT received a subsidy from the Scottish Executive to enable exchanges).

*Question 2: Do respondents agree with Ofcom's definition of the retail asymmetric broadband internet access market in the UK?*

Ofcom defines the retail product market at paragraph 4.24 as "asymmetric broadband internet access which as a minimum provides an always on capability, allows both voice and data services to be used simultaneously and provides data at speeds greater than a dial up connection. This market includes both business and residential customers."

We welcome the fact that this is a relatively broad and technology-neutral definition, which correctly places copper and cable-based services in the same market. It should also avoid some of the problems associated with the exclusion of IPStream from the 2003/04 market review (see response to question 1 above). We note that should BT provide asymmetric services in remote areas by means of alternative technologies such as wireless (with or without public subsidy), this could also be caught within the definition and subject to appropriate SMP obligations.

Our main concern with this definition is that it fails to distinguish the differing needs of business and residential broadband users. As Ofcom notes, a large number of businesses are content to use residential-oriented broadband products (usually for non 'mission-critical' applications) and the pricing of residential products does constrain to some extent the pricing of business-oriented products. However, there is a large class of business applications for which the provisioning and fault repair SLAs currently available with broadband products are unacceptable (eg a 5 hour fix time is available for leased lines but not for broadband). Business users are often forced to continue using leased lines, even though an ADSL-based solution might be more efficient and cost-effective. Alternatively they may choose to double up with two ADSL lines for increased resilience, or simply use the ADSL lines as backup for a leased line. By failing to distinguish these markets, Ofcom runs the risk that Market 3 (which will contain a disproportionate number of businesses) will be deregulated on the basis of an aggregate view, foregoing the opportunity to use regulatory leverage to improve the availability of business-grade products.

*Question 3: Do respondents agree with Ofcom's definition of the wholesale broadband access product market?*

Ofcom defines the wholesale product market at paragraph 4.120 as "asymmetric broadband access and any backhaul as necessary to allow interconnection with other Communications Providers which provides an always-on capability, allow both voice and data service to be used simultaneously and provide data at speeds greater than a dial-up connection."

As with the retail market definition, we welcome the broad technology-neutral nature of the definition, but are concerned that the definition does not recognise the difference between business-grade and residential wholesale products. We would strongly encourage Ofcom to identify separate retail markets for business and residential, and match these with separate wholesale markets.

We understand Ofcom's wish to avoid being too prescriptive in the definition of the backhaul market, but, it would helpful to provide some clarification of how 'necessary' would interpreted in the context of 'necessary backhaul'. For example, what is necessary for an established operator with a reasonably extensive geographic network may be different from what is necessary for a small market entrant.

We are unclear whether BT’s Wholesale Managed Broadband Connect product would fall within the definition, and request clarification of the principles that would apply.

*Question 4: Do respondents agree that the Hull area should be defined as a separate geographic market on the basis of the presence of common pricing constraints?*

Yes.

*Question 5: Do respondents agree with Ofcom’s methodology for assessing geographic variations in the competitive conditions in the wholesale broadband access product market?*

Ofcom identifies six possible approaches to assess geographic variation in competitiveness: current availability of cable based services, current availability of LLU-based services, planned availability of LLU-based services, LLU based entry likely, presence of a common pricing constraint, and areas in which services are provided over other network infrastructure.

We agree that these are all potentially relevant, but for the reasons given by Ofcom, it would be a mistake to place too much weight on approaches 4 and 5. We believe most weight should be given to the first three.

*Question 6: Do respondents agree with Ofcom’s analytical framework for defining geographic markets in the UK (excluding the Hull area) and the conclusions reached?*

We agree that it is appropriate to exclude smaller LLU operators from the analysis and focus on “Principal Operators” who are likely to provide a viable wholesale offering. Ofcom defines principal operators as those who will be able to serve at least 10% of homes and businesses in the UK by January 2008. Although we note Ofcom’s observation that the number of such operators is unchanged if the threshold is varied between 5% and 40%, we believe that the threshold of 10% is too low. Given the cost and complexity of establishing a supplier relationship with a wholesale broadband provider, it is most unlikely that an LLUO which serves only 10% of homes and businesses at January 2008 will provide a material competitive constraint within the period of this market review (to 2010). We suggest the threshold be raised to 30%.

We agree that the prospectively competitive ‘Market 3’ should be gated in terms of exchange size as well as number of principal operators. However, we are concerned that the threshold of 4 principal operators is too low. It is generally assumed that there need to be around 5 competitors present in a market to yield fully competitive behaviour, with a growing risk of price-following or other non-competitive behaviours as the number reduces below 5. Given that the count is based on operators who would be in a position to compete in the wholesale market (by virtue of their geographic rollout), not on operators who are actually competing in the market, there is additional reason to adopt a cautious approach in setting the threshold. We therefore suggest the threshold be raised to 5. (Ofcom may argue that the outcome is relatively insensitive to the choice of threshold, but that is not a reason not to change it, since the choice of threshold may become more significant following prospective industry consolidation.)

*Question 7: Do respondents agree that Ofcom has used relevant criteria for assessing SMP in the markets defined?*

Ofcom states at paragraph 5.28 that it is 'not aware of recent directly relevant evidence of anti competitive behaviour in these markets'. Although there have been relatively few disputes and complaints since the creation of Ofcom in 2003, this is in part because industry has focused its attention on the Telecoms Strategic Review and the Undertakings as the best way of addressing concerns over anti-competitive behaviour. Indeed, the fact that Ofcom found it necessary to impose the undertakings on BT (including EoI obligations relating to IPStream) is surely evidence of anti-competitive behaviour for the purpose of this test. Furthermore, between March 2000 and August 2003 there were some 20 investigations relating to BT's anti-competitive behaviour in broadband markets, including six in which the regulator found against BT:

| **Case opened** | **Subject** |
|---|---|
| Oct-00 | Refusal to offer ATM interconnect products (T Act) |
| Aug-01 | Non availability of rate adaption on business products (T Act) |
| Oct-02 | BT's refusal to supply VP migration and STM-4 concatenated (T Act) |
| Apr-03 | IPStream vs DataStream margin squeeze (T Act) |
| Jun-03 | Volume discount scheme for IPStream and Datastream (C Act) |
| Aug-03 | Price increase to DataStream VPs for VBR-rt and CBR |

*Question 8: Do respondents agree with the approach set-out by Ofcom for its market power assessment in the Hull area and its conclusion of finding Kingston to have SMP?*

*Yes.*

*Question 9: Do respondents agree with the approach set-out by Ofcom for its market power assessment in Market 1 and its conclusion of finding BT to have SMP?*

Yes

*Question 10: Do respondents agree with the approach set-out by Ofcom for its market power assessment in Market 2 and its conclusion of finding BT to have SMP?*

Yes

*Question 11: Do respondents agree with the approach set-out by Ofcom for its market power assessment in Market 3?*

We understand Ofcom's reluctance to address the question of BT's SMP in Market 3, given the rapid pace at which market conditions are changing. However, it is unlikely that conditions will have stabilised by May 2007, when Ofcom is due to publish its preliminary findings on SMP, and any finding of non-SMP is likely to be based on a degree of forecasting regarding the emergence of viable wholesale LLU offerings.

We are concerned that even if the non-SMP finding is correct on a forward looking basis, there may still be an interim period, following introduction of the new regime, where there is insufficient competitive constraint from LLU operators in Market 3. Premature withdrawal of regulation in this interim period could cause significant consumer harm and irreversible damage to broadband resellers who rely on purchasing BT Wholesale's products on a level playing field with BT Retail. This applies particularly to 'legacy' products such as IPStream and DataStream which many CPs will continue to rely on, but also on 21CN products such as Wholesale Broadband Connect.

We therefore strongly support the proposal in paragraph 5.128 to impose transitional remedies on BT, requiring BT to continue to provide wholesale broadband access throughout Market 3. This should include an obligation to provide new access products on reasonable request, and on fair and reasonable terms, an obligation not to unduly discriminate and appropriate transparency requirements. If any of these elements are missing, there is severe risk that BT will exploit this to the benefit of its downstream businesses, particularly in the business services market which is concentrated in Market 3. In determining the length of the transitional period, Ofcom should take account of:

- the minimum contract periods that broadband resellers are obliged to enter with BT Wholesale for backhaul capacity ('BT Central' pipes) – often 2 years or more;
- the time required for LLUOs to develop robust scalable wholesale propositions, particularly while attention is focused on their own retail sales channel;
- the cost and complexity of establishing a supplier relationship with a new provider of wholesale broadband – which means that few SPs will be able to use more than one wholesale provider as an alternative to BT, and SPs will wish to have a high degree of confidence before taking on a new supplier;
- the fact that availability of viable wholesale products for business purposes (eg with business grade provisioning and repair SLAs) may substantially lag the availability of wholesale products for residential purposes.

We believe it would be premature for Ofcom to conclude that BT does not have SMP in Market 3, but if Ofcom does reach this conclusion, we believe an appropriate duration for a transitional period would be a minimum of 2 years and preferably 3, with some form of review before the transitional obligations are lifted.

*Question 12: Do respondents agree with Ofcom's proposed regulatory remedies on Kingston in relation to the market for wholesale broadband access in the Hull area?*

Yes

*Question 13: Do respondents agree with Ofcom's proposed regulatory remedies on BT in relation to the market for wholesale broadband access in Market 1 and if so are there any particular implementation or compliance issues that you believe needs to be considered?*

Ofcom's proposed remedy for Market 1 is to impose access and non-discrimination obligations (Option 2) but no price controls. We agree that it is essential to impose access and non-discrimination obligations, but we disagree with the decision not to impose price controls. Ofcom appears to have concluded that the risk of 'determining an inappropriate market outcome' outweighs the benefit of preventing excessive pricing by BT. We would note that:

- Although the broadband market continues to evolve, it is some seven years since broadband services were first launched in the UK, and there is plenty of experience both in the UK and overseas on which to base the necessary LRIC cost models. Hence there is no reason to believe that the risk of setting the price too high or too low is materially greater than in other markets where LRIC has been imposed.

- Although there is a potential risk that LRIC pricing could deter efficient market entry, there is an equal risk that if excessive pricing by BT is permitted, this could encourage inefficient market entry. If Ofcom is genuinely concerned about deterring future market entry, this could be alleviated by erring on the generous side in the price control.
- It has been suggested that imposing price controls in rural areas would involve setting a relatively long amortisation period for LLU assets (in order to bring the price down to realistic levels) and that this could then set an unhelpful precedent in Market 3 where Ofcom wishes to sustain a relatively high price floor for BT's wholesale products in order to protect LLU investment. We do not accept that this would necessarily be a problem, and in any case, it would be inappropriate to bias the regulatory approach in Market 1 in order to promote a particular outcome in Market 3. The correct approach is to determine on an objective basis the appropriate amortisation period in each of the markets.
- The risk of deteriorating performance levels is probably the most significant, and we agree that Ofcom should be cautious about this, given the current disastrous performance of BT's broadband provisioning and fault repair. However, we understand the majority of the current problems are a consequence of underlying deficiencies in LLU products, and of the introduction of new interfaces between Openreach and BT Wholesale which effectively broke the pre-existing processes. (For example, BTW's failure to launch a 5-hour repair time variant is blamed on the performance of the underlying Openreach product, which achieves the specified 5-hour SLA in only 50% of cases.) In practice, we suspect the best approach for Ofcom will be to address the underlying problems with Openreach products first, and then if necessary, address performance problems with BT's wholesale products – which would take us beyond the period of this review. Any short term issues (such as failure to pass on SLAs/SLGs offered by Openreach) could be dealt with under reasonable access conditions. Finally, the risk of under-investment is normally associated with RPI-X price controls rather than cost-orientation *per se* (which arguably incentivises investment), so a possible compromise would be to impose a LRIC pricing obligation without the associated price control (as has been done to date with ethernet products).

Compared to the downside risks identified above, the risk of excessive pricing by BT is **more likely to materialise** and is likely to have a **far greater impact on consumers**. If the pros and cons are correctly balanced, we believe there is a clear case in favour of price controls.

If Ofcom adopts the proposed remedy, with no cost-orientation obligation, resellers will be exposed to the risk of margin squeeze by BT, for which the only protection at present is ex post Competition Law. Recent experience of Competition Act investigations suggests that these can take several years to complete, by which time irreversible damage may have been done to competition. We would encourage Ofcom to consider whether the reasonable access obligation could be interpreted in a way that prohibits unreasonable pricing (including pricing that causes a margin squeeze), and issue appropriate guidance to that effect.

*Question 14: Do respondents agree with Ofcom's proposed regulatory remedies on BT in relation to the market for wholesale broadband access in Market 2 and if so are there any particular implementation or compliance issues that you believe needs to be considered?*

See our response to Question 13.

*Question 15: Do respondents agree that the alternative broadband technologies referred to in this annex are unlikely to be sufficiently widespread or utilised within the period of this review to constrain prices in the market for wholesale broadband access services?*

Yes. (But it is still appropriate to include services delivered using these technologies within the market definition.)

Yours sincerely

**Richard Sweet**
Director of Government Affairs