TalkTalk Group

Narrowband Market Review

TalkTalk response to Ofcom's December 2016 consultation

March 2017

NON-CONFIDENTIAL VERSION

This is TalkTalk's response to Ofcom's consultation on its proposals for the Narrowband Market Review ('**NMR**') published on 1 December 2016.

1 Summary

1.1 TalkTalk supports the broad thrust of Ofcom's proposals as set out in its consultation on the NMR. In particular, we agree with Ofcom's proposal to remove price controls on WLR and on new ISDN lines after a transitional period. We also support the level of price cap that Ofcom proposes on existing ISDN lines.

1.2 However, at the same time, Ofcom should ensure that its deregulatory agenda does not have unintended consequences and maximises benefits for consumers, limiting the potential supernormal profits to BT's shareholders. Ofcom should therefore make a number of minor amendments to its proposals:

- on WLR, Ofcom should ensure that BT is forced to set the same price level in all parts of the UK. This will ensure that BT does not benefit from pockets of market power, where exchanges have not been unbundled, and where BT may therefore be able to exploit consumers.
- on ISDN, although we agree with setting a price cap at broadly the level proposed by Ofcom, and Ofcom's rationale of encouraging switching to newer IP-based voice services, we do not support Ofcom's proposal to allow supernormal profits to BT's shareholders in order to achieve this price level. Rather, Ofcom should amend the cost allocations in BT's Regulatory Financial Statements to allocate more duct costs to ISDN products, so that BT only achieves a normal rate of return on those products. This would lead to a lower price cap on LLU, Ethernet, and passive products, benefitting competition and consumers.
- a longer notice period should be enforced for large changes in WCO prices, to provide time for demand to be switched away from BT if it chooses to impose price increases.

1.3 These amendments will serve to prevent BT from exploiting its market power to the detriment of consumers without unduly restricting BT's freedom, or significantly reducing Ofcom's deregulatory agenda. Even if they were all imposed, the net impact of the NMR review would still be to meaningfully reduce the regulatory restrictions imposed on BT in fixed line markets.

1.4 TalkTalk has only commented on selected issues from the NMR in the response below. Where we have not commented on an issue, no inference should be drawn as to whether we agree or disagree with Ofcom's proposals.

2 Ofcom should amend its geographic market definition for WFAEL

2.1 Ofcom sets out its geographic market definition for WFAEL at §§4.106-4.114. It first, appropriately, defines there to be separate geographic markets in the Hull Area and in the rest of the UK, based on the fundamental differences between the conditions of competition in the Hull Area and the rest of the UK.

2.2 It then goes on to consider the issue of retail pricing, and notes the existence of the Universal Service Condition ('**USC**') which compels BT to set the same price for retail telephony across the whole of the UK, along with the history of national pricing by retail operators. Ofcom uses this to infer that there is a common pricing constraint in retail competition.

2.3 However, Ofcom then errs when it considers the implications of this common retail pricing constraint. It sets out its views on the implications of the retail pricing constraint in a single paragraph, §4.112:

> *We assess the wholesale geographic market in a setting where the hypothetical monopolist also has a retail arm (it is vertically integrated) and is subject to the USC. In such a setting, we consider the most likely strategy is for the upstream monopolist, given the national retail price, to set a geographically uniform wholesale charge. Setting low wholesale charges in low cost areas would risk entry and setting high wholesale charges in high-cost areas would risk undermining wholesale sales (conditional on there not being a margin squeeze in wholesale provision). Together this would create unsustainable geographic arbitrage opportunities between the wholesale charge and the retail price and prevent the USO provider's own downstream retail arm from trading profitably.*[1]

2.4 This analysis is fundamentally flawed in a number of respects.

2.5 **There is no evidence that setting low wholesale charges in low cost areas would risk entry into retail voice markets**. TalkTalk assumes that when Ofcom states this, it means entry into retail markets, rather than into the wholesale market.[2] Ofcom is wrong to state that setting low wholesale charges in low cost areas would risk entry. [✂]

2.6 [✂]:

- [✂]
- [✂]
- [✂]

2.7 [✂]

2.8 [✂] This runs directly counter to the unevidenced assertion at §4.112 of Ofcom's consultation paper.

2.9 **Setting high wholesale prices in high cost areas would not undermine wholesale sales.** The second element of Ofcom's assessment is that if BT were to set wholesale

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[1] Ofcom does not define "low cost areas" or "high-cost areas" anywhere in its consultation document. §2.10 of this submission provides TalkTalk's interpretation of these terms.

[2] For the avoidance of doubt, there would also not be entry at wholesale level- the low wholesale charges would reduce the potential profits to be made, and there are very substantial sunk costs of entry, such that entry solely to serve voice-based markets would not be commercially viable.

prices at a higher level in high cost areas, this would 'undermine wholesale sales'. Ofcom does not provide further detail on the mechanism by which it expects this would happen, but it appears unlikely in practice.

2.10 'High cost areas' are likely to coincide with areas where exchanges have not been unbundled by ISPs such as TalkTalk and Sky. Areas which are high cost are likely to be high cost because of high average line lengths and a low density of customers. The exchanges serving high cost areas will therefore have a lower number of lines than average, making them less commercially viable for unbundling. In what follows, it is assumed that high cost areas have not been unbundled for MPF by any ISPs.

2.11 Therefore, customers facing wholesale price increases from BT will not be able to substitute to any operator other than BT, as WLR will be required in order to obtain fixed line services. As such, for high wholesale prices to undermine sales volumes, at least one of the following must be true:

- customers must be willing to substitute from fixed lines to mobile in the event of prices increasing.[3] However, Ofcom has already in its analysis (at §§4.47-4.53) ruled out fixed-mobile substitution as an effective competitive constraint on a monopoly provider of WLR. As such, this cannot be an effective competitive constraint.
- customers must be willing to move from having telephone access to not having any way of making or receiving voice calls.[4] This appears completely implausible, given the centrality of communications services to modern life.
- operators must be willing to unbundle more exchanges in the event that BT increases its wholesale prices in non-unbundled areas. TalkTalk is the operator which has unbundled the most exchanges in the UK. However, [✂].[5] There is thus little prospect of further unbundling, given the small scale of exchanges in high cost areas, even if BT chooses to increase wholesale prices in non-unbundled areas.
- prices above the competitive level must lead to entry into the wholesale market, through infrastructure competition. However, given that these areas have not been profitable even to unbundle for broadband purposes, it is implausible that it would be commercially viable for a new entrant to construct new infrastructure in order to compete in the voice-only market.[6]

2.12 However, as can be seen from the above, none of these constraining factors, whether on the demand side (fixed/ mobile substitution; stopping having any type of phone or broadband access) or supply side (increased unbundling; new entry) will act as an effective constraint against BT increasing wholesale prices in areas which

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[3] This substitution could be either substitution on a call-by-call basis, or giving up the landline altogether in favour of either a new or existing mobile connection.

[4] If they have a mobile phone, this is covered in fixed-mobile substitution above.

[5] See §6.9 of the Consultation document.

[6] See §6.25 of the Consultation document, which sets out that Ofcom does not consider it likely that MPF would be used to serve fixed voice-only customers.

have not been unbundled. As such, BT will be able to profitably increase prices in non-unbundled areas, to the detriment of customers in those areas, and to the detriment of retail competitors. It should be noted that this analysis of supply-side factors appears to be aligned with Ofcom's own conclusions on Wholesale Call Origination ('**WCO**') at §4.195 of the consultation document, where it states that '*barriers persist to serving those consumers who are outside the LLU footprint or cannot be viably supplied using MPF*'. There appears no reason why the analysis would be different for WLR.

2.1 The implications of Ofcom's flawed market definition for remedies

2.13 Ofcom's errors in geographic market definition for WFAEL in turn mean that the pricing remedies which Ofcom sets out at §§7.39-7.42 will fail adequately to protect consumers in areas which have not been unbundled from BT using its market power to increase prices and extract supernormal profits.

2.14 Equally, however, TalkTalk agrees with Ofcom that in areas which have been subject to unbundling, and/or Virgin Media has rolled out its network, BT will not have sufficient market power to raise prices in a profitable manner to the detriment of consumers. The fundamental problem is that constraints in these competitive areas will not protect consumers in non-unbundled areas due to BT's ability to engage in geographic price discrimination. That is, while the analysis in §7.40 is appropriate in areas which have been unbundled, it is inappropriate in non-unbundled areas.

2.15 There are therefore two regulatory options available to Ofcom to remedy the potential harm to consumers in non-unbundled areas:

- a charge control could be imposed solely in areas which have not been subject to unbundling. However, such a price cap is likely to be difficult to implement, as it will require cost data on a subset of exchanges, rather than all exchanges.
- a condition could be imposed on BT that it must apply geographically averaged prices in the WFAEL market, such that a single price pertains across the whole of the UK. This would permit the uncompetitive areas to be 'protected' by the competitive areas, substantially eliminating the profits to BT from increasing its prices above competitive levels.

2.16 It would seem appropriate for Ofcom to impose a remedy on BT mandating it to apply geographically averaged prices for WLR. This would still remain deregulatory compared to the current situation, where BT faces the same price cap in all parts of the country. BT would be permitted to set whatever price it wanted across the country, and would therefore gain considerable pricing freedom. At the same time, customers in deep rural areas would be protected from harm.

2.17 It is also vital that, following the removal of price caps, Ofcom vigorously enforces the non-discrimination and EoI obligations which will apply to BT in WFAEL. The removal of price caps creates greater scope for BT to discriminate (for example, by applying volume discounts in a discriminatory manner) and Ofcom will therefore need to constantly scrutinise BT's commercial policies around WFAEL products to prevent upstream market power being leveraged into retail markets. It will also be important for Ofcom to proactively enforce BT's Competition Act obligations not to margin squeeze its rivals, including in wholesale markets where BT Wholesale may bid against other firms for sizeable contracts with other suppliers, and where margin squeeze may not be as transparent to BT's competitors which have been harmed.

3 Wholesale call origination price changes should be subject to a longer notice period

3.1 TalkTalk supports Ofcom's proposal (see §7.47) not to impose a price cap on BT's provision of wholesale call origination, and instead impose a fair and reasonable charges obligation. Ofcom is correct that the market has become more competitive over the past few years, and that as such BT's market power has diminished (while still remaining significant).

3.2 However, the removal of the charge control on WCO creates risks that BT would have the ability suddenly to impose large price increases on its wholesale customers, such that those customers would wish immediately to switch a large proportion of their demand to other providers, in order to avoid paying prices well in excess of competitive levels.

3.3 Based on Ofcom's currently proposed regulation, customers of BT's WCO product would not be able to avoid paying excessive prices, as they would not be able to switch their demand away within the 56-day minimum notice period which Ofcom is mandating (§7.154). This creates a degree of short-run market power which Ofcom's current proposed remedies do not adequately deal with.

3.4 There are several steps which would have to be taken in order for a customer to switch demand away from BT's WCO product:

- it would need to draw together a list of alternative suppliers of WCO;
- it would need to draft and send invitations to tender to those alternative suppliers;
- those alternative suppliers would need to respond to the invitation to tender;
- the customer would then need to select a preferred bidder, negotiate with that bidder over any details, and finalise the agreement;
- finally, there would be a migration process to take retail customers from one WCO provider to a different WCO provider.

3.5 This whole process is likely to take considerably in excess of 56 days. The exact period which it would take is likely to vary depending upon the identity of the firm switching its demand, the number of customers that firm has, and the competitiveness of the WCO market from time to time. However, the need to be able to switch sufficiently fast in response to price rises clearly points to Ofcom extending the notice period.

3.6 Consequently, Ofcom should increase the notice period which BT has to provide for significant price rises (those which exceed 5% over a specified period of a year). For such price rises, although not for smaller ones, BT should have to give at least 90 days' notice to its customers. This will make it easier for these customers to switch provider before they have to pay a significant amount extra to BT for WCO services. Such a condition would balance BT's commercial freedom with protection of customers from BT's market power.

3.7 An increased notice period would also make it less likely that BT would increase WCO prices in the first place. BT would recognise that its profits from increasing prices would be lower, as it would have a shorter period of monopoly power before it lost volumes. Such a change would therefore directly increase allocative efficiency, by forcing prices to be closer to costs. There would be no offsetting loss of allocative efficiency from prices potentially being misaligned with costs during the 90 day notice period, as the costs of providing WCO are predictable and not subject to sudden shocks either upward or downward.

3.8 This extended notice period is particularly important given Ofcom's proposal, at §7.209, to remove the requirement not to discriminate unduly. Given the potentially long time period to appoint an alternative provider of WCO services, the lack of regulation in this area by BT could be used to target individual rivals, who may not be able to switch away sufficiently quickly. The prospect of indirect constraints from mobile telephony is itself of little relevance: BT will recapture much of this demand, as it is (through EE) the largest MNO operating in the UK, and also supplies Virgin Media (the largest MVNO) on a wholesale basis. This will make increasing WCO prices considerably more profitable.

3.9 Where BT proposes to impose a price increase on a wholesale customer which would amount to undue discrimination (if a no undue discrimination condition were in place), Ofcom should therefore propose a longer notice period, of 120 days, to provide greater scope for that wholesale customer to switch its demand away from BT. This will act to mitigate BT's ability to target its rivals, while allowing BT to discriminate between different customers in order to meet competition in the wholesale calls market.

3.10 Furthermore, in the same way as Ofcom should mandate a single national price for WLR once price caps are removed, a single national price should also be mandated for WCO. Once more, this would be in order to prevent BT from being able to exploit geographically isolated pockets of market power in areas where there are no competing operators.

4 Ofcom has proposed an appropriate price cap on ISDN products, but should not permit BT excess profits on these services

4.1 At §§8.20-8.33, Ofcom sets out its proposals on the form of regulation which will apply to ISDN2 and ISDN30 services.[7] Acknowledging that BT holds market power in these products, Ofcom considers that its needs to impose a charge control in order to prevent the '*risk that BT can use its SMP to price excessively*'. TalkTalk agrees that a price cap is warranted in this market.

4.2 However, unusually, Ofcom does not propose a price cap which is set on the basis that it is oriented to the costs to BT of providing ISDN products. It argues that this is appropriate because '*we would need to make adjustments to the cost figures in order to take account of the heavily depreciated nature of the assets as, while in accounting terms the assets have been fully depreciated, the products are still being used. This means that the assets' accounting value may underestimate their true economic value*. *Second, requiring the charge controls to be set on the basis of projected costs could risk prices being set at a level that would result in reduced incentives to migrate to IP-based services*'.[8]

4.3 As a result of these considerations, Ofcom proposes a price cap for existing ISDN2 and ISDN30 lines which results in constant prices in nominal terms, leaving prices well in excess of a cost-oriented level.[9]

4.4 TalkTalk agrees that it is appropriate to set charges for ISDN2 and ISDN30 products at a level which preserves incentives to migrate to IP-based services. This is a valid policy goal for Ofcom to pursue, and IP-based services offer significant consumer benefits over the legacy ISDN technologies.

4.5 However, we do not agree that, as a result, it is appropriate for BT to earn returns in excess of its cost of capital. Ofcom's proposals are based on the finding that the accounting value of the assets allocated to ISDN products is insufficient to lead to economically efficient prices; as a result, Ofcom proposes to set prices well above a cost-reflective level. In the alternative, Ofcom could amend cost allocations, so as to allocate more assets to ISDN products, and then set prices at a cost-reflective level. This would have the (beneficial) effect of pushing down prices on other products.

4.6 The appropriate way to do this would be for Ofcom to amend the allocations within BT's regulatory financial statements (RFS) so as to allocate more common costs to ISDN products. By definition common costs cannot be allocated to a specific product with any degree of certainty, because they are shared across a wide range of products and are not specifically driven by any of them. By allocating more common

[7] Where those products are already in place, although not for newly provisioned products beyond a transitional period. Throughout the rest of this section, it should be read that comments about the price cap to be applied only refer to these legacy lines.

[8] See §8.28 of the Consultation document

[9] See §8.33 of the Consultation document

costs to ISDN products, there would be lower supernormal profits on these products, while at the same time prices on some other products would be both lower and closer to their incremental costs of provision, without there being subnormal returns on these products.

4.7 More specifically, Ofcom should allocate more duct costs to ISDN products, so that the proposed price cap of constant nominal prices is cost-reflective. Allocating more duct costs to ISDN would reduce the prices of a wide range of products in a manner which is likely to be broadly neutral between operators– WLR, MPF, duct and pole access (DPA), dark fibre and Ethernet products would all see price reductions.

4.8 Such a reallocation of duct costs would therefore not distort the choice between different technologies. For example, there would be equal reductions in the price of WLR, MPF and DPA products, which would not change providers' choices between these products. At the same time, these downstream retail markets are competitive, so cost reductions should be passed through to consumers, increasing their welfare.

4.9 A reallocation of duct costs would also not distort investment incentives. As there would be a reduction in the price of passive DPA products due to lower duct cost allocations, operators will retain incentives to roll out competing networks through the use of BT's passive infrastructure. Under Ofcom's proposed DPA remedies, all operators will have the potential to install their own fibres into BT's passive infrastructure. It will also not conflict with the 'fair bet' principle, given that BT has been permitted high returns on its ISDN products for many years, which would have covered any risk inherent in product development, and that the high returns to ISDN products do not, according to Ofcom's analysis, derive from opex efficiencies, but from the use of fully depreciated assets.[10]

4.10 Finally, a reallocation of duct costs will not harm BT's incentives to invest in efficient projects. BT will continue to earn at least its cost of capital across its portfolio of products; indeed, in the first two years of the charge control, it will continue to make supernormal returns as prices for WLR, MPF, etc are glidepathed to the new levels reflecting a lower asset allocation. Furthermore, BT has historically earned high returns on ISDN products, notwithstanding Ofcom's regulation, and will have comfortably covered the cost of capital required to have had a 'fair bet' on its ISDN assets.

4.11 It would therefore be appropriate for Ofcom to amend the RFS in order to allocate an increased quantum of duct costs to ISDN products. This would lead to increased consumer welfare for the consumers of other fixed line products, without distorting incentives and harming dynamic efficiency. It would also increase allocative efficiency, as prices across a range of products would be closer to their incremental costs. Finally, it would tend to be market expanding, particularly for products such as

[10] The fully depreciated nature of these assets means that accounting and economic depreciation were not aligned with each other in earlier years, and as such that returns in earlier years are likely to have been understated.

Ethernet and dark fibre where take-up is currently far from ubiquitous; and will help incentivise switching to IP-based products.

4.12 Ofcom should therefore reconsult on this issue, making appropriate amendments to its reasoning, but without changing the price caps.

5 Quality of service

5.1 The evidence presented by Ofcom on Openreach's quality of service for products covered by the NMR demonstrates that the minimum service standards previously set by Ofcom have been too low, and have failed to drive improvements in Openreach's performance.

5.2 There are several areas in which this lack of improvement is seen:

- at Figure 9.1, Ofcom provides data on 12-day appointment availability for WLR. This shows average performance sharply lower in 2015/16 than in 2014/15.
- At Figure 9.3, data on WLR orders provisioned on time shows no change in Openreach's performance over the period examined.
- There is no clear trend in Openreach's performance in on time faults restored, shown at Figure 9.5, and Openreach has breached its minimum standard on multiple occasions.
- The average number of working days until an ISDN2 appointment has been available (Figure 9.6) appears to have increased over the period shown.

5.3 It is therefore imperative that Ofcom imposes stringent quality of service obligations on Openreach as part of the NMR. We agree with Ofcom's comment, at §9.43, that in the absence of regulation Openreach is not sufficiently incentivised to maintain or improve its current levels of quality of service.

5.4 As part of its Wholesale Local Access review ("**WLA**"), Ofcom should look to increase the minimum service standards which apply to WLR lines. We agree that it is appropriate for Ofcom to do this as part of the WLA, which will enable alignment in quality of service between lines based on WLR, and those based on MPF.

6 Ofcom's proposals on wholesale call termination (WCT) are appropriate

6.1 TalkTalk agrees with Ofcom's proposals to impose a charge control on all providers of wholesale call termination, as set out at sections 12 and 13 of its consultation. We agree that all providers hold SMP over termination on their networks, and that in the absence of regulation it is likely that WCT prices would be well in excess of costs. This is particularly because the charge would be imposed not on a CP's own customers, but rather on the customers of other operators.

6.2 In addition, the simplicity of an approach based around the same price cap applying to all operators (see §13.77) has considerable advantages. It prevents inefficient operators passing their inefficiencies into the charges paid by the customers of other operators, and thereby creates incentives for efficiency. We agree (§13.76) that compliance costs are reduced by a single charge cap that applies at all times of day (§15.27 *et seq*).

6.3 Furthermore, it is appropriate for BT to continue to have cost accounting obligations on its provision of WCT, as proposed by Ofcom at §§12.121-12.124 of its consultation. In the absence of such an obligation, there is a risk of the allocation of costs, both to WCT and to other markets, being distorted through undermining the accounting separation proposals at §§12.107-12.111. It is vital across all regulated markets that there is effective cost accounting and appropriate cost allocation, in order to give effect to the equivalence of input obligations that Ofcom has, rightly, placed on BT.

6.4 The issue of whether there should be differential regulation for calls arising from non-EU areas which themselves have higher termination rates is a complex one, and Ofcom is right to flag the potential costs from systems development and billing complexity to make use of a differential price cap. We therefore broadly agree with Ofcom's proposals as set out at §13.116.

6.5 However, TalkTalk does not agree with Ofcom's proposals for the cost of capital to be used when setting the price cap for WCT. The 2016 BCMR statement already allowed BT to obtain an excessive return on its assets, and this error is now magnified by the lower costs of capital facing UK firms. In particular, the risk free rate in the 2016 BCMR was inappropriate, and Ofcom's reasoning for leaving it inappropriately high was in part based on the assertion that risk free rates had 'stabilised' (§A30.43).[11] Since then, risk free rates have fallen further, and that assertion has clearly been falsified. Ofcom should therefore reassess the risk free rate, and the cost of capital derived from it, on the basis of an RFR no higher than 0%. This is likely to lead to a substantial fall in the WACC from that proposed at §14.23.

7 Ofcom is right to propose deregulation in competitive areas

7.1 TalkTalk supports Ofcom's proposals only to regulate where strictly necessary, and to remove any regulation which is not required in order to remedy the degree of market power which BT holds in the various markets covered by the NMR. In that context, this section briefly sets out a number of areas not picked up above in which Ofcom proposes to deregulate, and where TalkTalk supports Ofcom's proposals.

[11] Ofcom (2016), Business Connectivity Market Review Statement: Annexes.

7.1 Ofcom is correct to remove the requirement for a process for new forms of network access

7.2 At §§7.207-7.208, Ofcom proposes to remove the requirement for BT to offer new forms of network access to its TDM network, in light of the maturity of that network. TalkTalk considers that this is appropriate given the lack of innovation in the TDM network, with developments focussed on VoIP technologies.

7.2 Ofcom is correct to remove the requirement for BT to notify technical information

7.3 TalkTalk agrees with Ofcom's proposal, at §7.210, to remove the requirement for BT to notify technical information in the markets covered by the NMR.

7.3 Ofcom is correct not to regulate the prices of new ISDN lines

7.4 As set out at §4.4 above, TalkTalk agrees with Ofcom's policy position that switching to VoIP services is a reasonable goal to adopt, and that in order to encourage such a switch, it is reasonable to deregulate new ISDN lines. At the same time, given the enduring market power of BT and high returns, we consider that it is essential for Ofcom to continue to impose a price cap on existing ISDN lines.