Wholesale unmetered narrowband Internet termination services - UK excluding Hull area market

Identification and analysis of market and Determination on market power

Final Explanatory Statement and Notification

Published: 28 November 2003
## Contents

<table>
<thead>
<tr>
<th>Section</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Summary</td>
<td></td>
</tr>
<tr>
<td>Chapter 1</td>
<td>Background and consultation process</td>
</tr>
<tr>
<td>Chapter 2</td>
<td>Final decision</td>
</tr>
<tr>
<td>Chapter 3</td>
<td>Discontinuation of current regulation</td>
</tr>
<tr>
<td>Annex A</td>
<td>Formal Notification of decision under the Communications Act 2003</td>
</tr>
<tr>
<td>Annex B</td>
<td>List of representations received in response to the August 2003 consultation document</td>
</tr>
<tr>
<td>Annex C</td>
<td>Response to comments on market definition</td>
</tr>
<tr>
<td>Annex D</td>
<td>Discontinuation notice</td>
</tr>
</tbody>
</table>

## Further copies of this document

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Summary

A new regulatory regime

S.1 A new regulatory framework for electronic communications networks and services entered into force in the UK on 25 July 2003. The basis for the new framework is five new EU Communications Directives that are designed to create harmonised regulation across Europe.

S.2 The new Directives require National Regulatory Authorities (“NRAs”), amongst other things, to carry out reviews of competition in communications markets to ensure that regulation remains appropriate in the light of changing market conditions.

S.3 As part of this series of reviews, on 26 August 2003 Oftel published a consultation document entitled *Wholesale unmetered narrowband Internet termination services - UK excluding Hull area market* ("the August consultation document"). That document followed an earlier consultation document published on 17 March 2003 ("the March consultation document") and invited comments on the Director's proposal for defining the relevant wholesale market and assessing the state of competition in that market. The period of consultation closed on 26 September 2003.

S.4 As required by the Directives, the draft decision was also sent to the European Commission and to other NRAs as, in the Director’s opinion, the proposal may have affected trade between Member States. The final decision included in this document is also being communicated to the European Commission.

Summary of proposals

S.5 Having considered all responses to the March and August consultation document, the Director is setting out in the present document his final decision. This is summarised below.

Identification of markets

S.6 The wholesale services under consideration in this document are those such as SurfPort24 which are used by ISPs to provide retail unmetered narrowband Internet access. In relation to these wholesale services, the Director has decided to identify the following economic market in accordance with competition law principles, for the purpose of ensuring that regulatory obligations are proportionate and objectively justifiable;

- the market for wholesale unmetered narrowband Internet termination for Internet traffic originating in the UK excluding the Hull area
S.7 This market definition is unchanged from that proposed in the August consultation document.

**Assessment of market power**

S.8 The Director has decided that, in the market for wholesale unmetered narrowband Internet termination for Internet traffic originating in the UK excluding the Hull area:

- no supplier has Significant Market Power (SMP), either individually or in combination with one or more other undertakings.

S.9 This decision on SMP is unchanged from that proposed in the August consultation document.

**Regulatory implications**

S.10 The new Directives allow Member States to carry forward some existing regulation until the market reviews have been completed and any new conditions put in place. As NRAs were not able to notify draft proposals to the European Commission before 25 July 2003, the Director issued notices to relevant communications providers to maintain some of the regulatory regime that existed before that date. For the market that is the subject of this document, specified licence conditions were made to continue in force by a continuation notice given to BT on 23 July 2003 (the ‘Continuation Notice’). This Continuation Notice came into effect on 25 July 2003.

S.11 As the Director has now concluded that no supplier has SMP in this market, the present regulatory requirements on BT set out in the respective Continuation Notice will not be reproduced within the new regulatory framework. Those obligations include, among other things, requirements to supply to any person who reasonably requests such services in this market and not to show undue preference or discrimination in the provision of such services. This will require the Director to discontinue the aforementioned provisions that were continued on 25 July. More details of the regulation to be removed, and how this will be done, are contained in Chapter 3 of this document.
Chapter 1

Background and consultation process

Scope of this review and the extent of existing regulation

1.1 This explanatory statement sets out the Director’s conclusions with regard to the market for wholesale unmetered narrowband Internet termination for Internet traffic originating in the UK excluding the Hull area. This market includes wholesale services, for example SurfPort24, which are used by ISPs to provide retail unmetered narrowband Internet access services. Unmetered services provide dial-up Internet access on a flat rate basis with no call charges, as compared to metered services for which there are per minute call charges.

1.2 In relation to wholesale unmetered narrowband Internet termination services, BT is currently obliged to supply to any person who reasonably requests such services (Condition 43). Linked to this obligation is a prohibition on undue preference and undue discrimination (Condition 57) and the requirement for publication of charges, terms and conditions (Condition 58). BT currently provides services such as SurfPort24 under these conditions.

The basis for market reviews

1.2 The review of competition completed by this document is a requirement of the new European regulatory framework for electronic communications networks and services, which entered into force on 25 July 2003. The framework is designed to create harmonised regulation across Europe and is aimed at reducing entry barriers and fostering prospects for effective competition to the benefit of consumers. The basis for the new regulatory framework is five new EU Communications Directives.

1.3 The new Directives require National Regulatory Authorities (“NRAs”) such as Oftel to carry out reviews of competition in communications markets to ensure that regulation remains appropriate in the light of changing market conditions. This document concludes for this market the review process that the Director had commenced in anticipation of the new regime.

1.5 The detailed requirements and guidance concerning the conduct of market reviews are provided in the EU Communications Directives, the Act and in additional documents issued by the European Commission and Oftel. As required by the new regime, in conducting this review, Oftel has taken the utmost account of the Commission’s Recommendation on relevant product and service markets, adopted on 11 February 2003 (the “Recommendation”) and the Commission’s guidelines on market analysis and the assessment of significant market power (“SMP”) (the “SMP Guidelines”).
1.6 Four of the new Directives were implemented in the UK on 25 July 2003. This was achieved via the Communications Act 2003 (“the Act”). The Act provides for functions, powers and duties to be carried by Ofcom, which include those flowing from those four EC Communications Directives. Certain existing functions are also transferred to Ofcom. However, Ofcom will not assume full functions under the Act until later this year. Accordingly, transitional arrangements are in place to enable the Director to carry out certain functions until they are transferred to Ofcom later in the year. Therefore, references in those provisions of the Act to Ofcom are, for the present time, to be read as references to the Director.

1.7 The August consultation document provides, in Chapter 1, more comprehensive details of:

- the purpose and objective of these new Directives;
- Ofcom's powers to conduct market reviews; and
- the detailed procedural requirements and guidance that Ofcom has taken into account in conducting this review, in order to define markets and to assess whether any providers have SMP.

Consultation processes


1.9 A second stage of consultation began on 26 August 2003 (“the August consultation document”). The August consultation document updated the analysis, based on market developments and responses to the first stage of consultation. The second stage of consultation, which closed on 26 September 2003, invited representations from UK stakeholders, the European Commission and other NRAs.

1.10 NRAs must send the European Commission a summary notification form of their draft proposals. Ofcom's notifications are published on the European Commission's website at http://forum.europa.eu.int/Public/irc/infso/ecctf/library?l=/uk&vm=detailed&sb=Title

Summary of the latest consultation

1.11 This statement should be read in conjunction with Ofcom's March and August consultation documents to understand the full reasoning for the Director's decision.
1.12 The August consultation document laid out the Director's proposed market definition and his proposal that no supplier in that market should be designated with SMP. A summary of responses is contained in Annex B.

1.13 The Director has considered the responses carefully and taken utmost account of the points made when setting out in the present document his final decision on market definition and market power in that market. Where new and substantive points are made, they are addressed in Chapter 2 below. Where points were repeated from the first stage of consultation, and have thus been considered already in Oftel's analysis, this document does not reprise Oftel's previous response.

1.14 The Director's formal Notification of this decision, as required under section 79(4) of the Act, is provided at Annex A.
Chapter 2

Final decision

2.1 The Director's final decision, taking full account of representations from all stakeholders, is set out below, covering:

- market definition;
- an assessment of whether any network operators have SMP; and
- the regulatory implications of the SMP assessment.

2.2 Section 79(1) of the Act provides that before a market power determination may be made, the Director must (i) identify the markets which are, in his opinion, the ones which, in the circumstances of the UK, are the markets in relation to which it is appropriate to consider such a determination; and (ii) analyse those markets. The Director is, as noted above, required to take due account of all applicable guidelines and recommendations issued by the European Commission. Under section 79(4) of the Act, the Director may identify markets and make market power determinations by way of publication of a notification. The notification at Annex A is such a notification.

Market definition

2.3 The Director has decided to define the relevant economic market as:

- the market for wholesale unmetered narrowband Internet termination for Internet traffic originating in the UK excluding the Hull area.

2.4 The chief features of the market definition remain as proposed in the August consultation document (at Chapter 2 and Annexes A and B).

2.5 In response to the August consultation document, stakeholders generally agreed or had no comment on the relevant economic market for this review (see Annex B). Where comments were received, these focussed on the approach and methodology Oftel had used rather than conclusions that Oftel had reach with regard to the relevant market.

2.6 The comments that were received from the European Commission and one other respondent focus on aspects of Oftel’s methodology for the analysis of demand-side substitutes at the retail level and the approach to wholesale market definition. Oftel has responded in detail to the points raised in relation to the market definition in Annex C.

Retail level demand-side substitution
2.7 In relation to Oftel’s demand side analysis at the retail level, one respondent comments on Oftel’s SSNIP (small but significant non-transitory price increase) test, in particular the critical loss factor and interpretation of consumers reactions to a 10% price increase. However even taking into account some of the revised assumptions that the respondent suggests, Oftel’s view is that the revised critical loss estimates are still consistent with Oftel’s conclusions at the retail level. In particular Oftel would stress that:
- Oftel’s analysis does not rest solely on the stated switching percentages. They are used to complement consumer survey information on usage patterns and reasons for use of particular packages.
- The calculation is relatively conservative because Oftel's previous market research has found that fewer customers actually switch than claim they would in response to a hypothetical question about switching behaviour. Therefore the survey results are expected to be over-estimates of switching behaviour.

**Wholesale market definition**

2.8 The European Commission and one other respondent comment that Oftel’s demand side analysis at the wholesale level could take into account demand in addition to the derived demand from unmetered retail services. The European Commission notes that unmetered wholesale services could be used for retail services other than just unmetered Internet access.

2.9 Oftel accepts that unmetered wholesale services can in principle be used for a number of retail services other than unmetered Internet access, although is not aware that this is currently widespread in the UK. However, the affect of this on demand conditions at the wholesale level would still be considered in the context of looking at demand derived from the retail level. In fact Oftel effectively considered the extent of wholesale demand-side substitutability at the wholesale level by assessing the nature of supply-side substitutability at the retail level. Therefore, Oftel's derived demand approach is consistent with the observations made by the European Commission and the other respondent.

**SMP assessment**

2.10 As referred to above, under section 79(1) of the Act the Director must carry out an analysis of identified markets before making a market power determination. Further, section 45 of the Act details the various conditions that may be set under the new regulatory regime. Section 46 details upon whom those conditions may be imposed. In relation to SMP services conditions, section 46(7) provides that they may be imposed on a particular person who is a communications provider or a person who makes associated facilities available and who has been determined to have SMP in a “services market” (ie: a specific market for electronic communications networks, electronic communications services or associated facilities). Accordingly, having identified the relevant markets as above, the Director is required to analyse those market in order to assess whether any person
or persons have SMP as defined in section 78 of the Act (which implements Article 14 of the Framework Directive).

2.11 The Director has decided that, in the market for wholesale unmetered narrowband Internet termination for Internet traffic originating in the UK excluding the Hull area:

- no undertaking has SMP, either individually or in combination with one or more other undertakings.

2.12 This assessment of SMP is unchanged from the August consultation document, which contained comprehensive details of Oftel's analysis (at Chapter 3 and Annex C). Oftel has reviewed that analysis in the light of representations made by stakeholders.

2.13 In response to the August consultation document, respondents generally agree that operators are able to compete in this market. However, UCKTA and two other respondents reiterate their concerns about BT’s vertical integration and comment that Oftel’s discussion of the applicability of article 14(3) of the Framework Directive should have provided a more specific discussion of this market.

2.14 Oftel acknowledged, in paragraph 3.50 of the August consultation document, that Article 14(3) of the Framework Directive allows NRAs to impose conditions to deal with anti competitive leverage from SMP markets into a closely related market, where conditions imposed in those SMP markets are not a sufficient remedy. Oftel will use Article 14(3) where it is appropriate to do so. Also, as mentioned at paragraph 3.56 of the August consultation document, Oftel will not hesitate to use the Competition Act 1998 to address instances of suspected leverage. Chapter 2 of Oftel’s recent statement Competition Act investigation into alleged anti-competitive practices by BT in relation to its BT Broadband Product - 11 July 2003 set out its approach to such investigations.

2.15 In its August consultation document Oftel presented much evidence and analysis that supported the existence of effective competition in this market and has received no substantive comment to contradict that. In addition, no evidence has been offered by respondents to indicate that leverage of market power from an upstream market is likely to affect competition in this market in the future, or that competition law would be insufficient to deal with this. However, this does not mean to say that Oftel considers future leverage to be impossible or rules out any future changes to access products such as FRIACO. Rather, Oftel’s view is that the current evidence of competition and absence of specific leverage concerns means that use of Article 14(3) of the Framework Directive would not be an appropriate or proportionate measure. This is also relevant to the issue of horizontal leverage from broadband access that one respondent mentions.
2.16 One respondent questions OfTEL's analysis of market shares as its view of the market suggests that BT has a higher market share than OfTEL had presented. However, the estimates the respondent uses are not consistent with the confidential evidence OfTEL has acquired from the industry via formal information requests.

**Regulatory Implications**

2.17 The formal statement of the Director's decision on market definition and SMP is made by means of a Notification under section 79(4) of the Act. This Notification is at Annex A below.

2.18 The Director's decision that no supplier has SMP means that any regulation continued from the previous regulatory framework needs to be lifted. Article 16(3) of the Framework Directive (2002/21/EC) states that where the NRA concludes that no undertaking has SMP, "it shall not impose or maintain any of the...[SMP-related]...regulatory obligations". The discontinuation of current regulation is set out in Chapter 3.

**Future reviews**

2.19 OfTEL considers it important to continue to monitor this market. However, OfTEL is not able to comment on the possible requirement and timing for any future review as this will be a matter for Ofcom to decide.
Chapter 3

Discontinuation of current regulation

Introduction

3.1 The new Directives allow Member States to carry forward some existing regulation until the market reviews have been completed. The power for the Director to do this is contained in paragraphs 9 and 22 of Schedule 18 to the Communications Act 2003 (the 'Act'). As national regulatory authorities ('NRAs') were not able to notify draft proposals to the European Commission before 25 July 2003, the Director issued continuation notices to relevant communications providers to maintain some of the regulatory regime that existed before that date.

3.2 For the market that is the subject of this document, specified licence conditions were made to continue in force by a continuation notice given to BT on 23 July 2003 (the 'Continuation Notice'). That Continuation Notice came into effect on 25 July 2003. Further details are contained in the Director’s consultation document (www.ofTEL.gov.uk/publications/licensing/2003/cont0703.htm) and statement (www.ofTEL.gov.uk/publications/eu_directives/cont_notices/cont0903.pdf) on the continuation process.

3.3 Paragraph 9 (11) of Schedule 18 to the Act imposes a duty on the Director, as soon as reasonably practicable after giving such a Continuation Notice, to take the necessary steps to enable him to decide whether or not to set a condition (including setting a SMP condition) for the purpose of replacing the continued obligation. When he has done so, paragraph 9 (12) of Schedule 18 to the Act requires the Director to give a notice that the continuation notice ceases to have effect, and that he must do this as soon as reasonably practicable after taking a decision to impose (or not to impose) conditions under the new regime.

3.4 As mentioned in paragraph 1.2 of the August consultation document, the regulation applying to BT in the unmetered narrowband Internet termination market is the obligation to supply to any person who reasonably requests such services (Condition 43). Linked to this obligation is a prohibition on undue preference and undue discrimination (Condition 57) and the requirement for publication of charges, terms and conditions (Condition 58).

3.5 As the Director has now concluded that no supplier has SMP in this market, the present regulatory requirement on BT contained in Condition 43 which was set out in its Continuation Notice in respect of the market defined in this document will now be discontinued. This will require the Director to give a notice (the 'Notice') to that effect. The discontinuation Notice for BT is included at Annex D of this explanatory statement.
3.6 The effect of the discontinuation Notice will be to discontinue the continued condition 43; in so far as it applies to the market identified in this document.

The process for discontinuing continued provisions in Continuation Notices

3.7 The Director recently issued a consultation document “Discontinuing licence conditions after 25 July 2003” on 2 October 2003 (available at http://www.oftel.gov.uk/publications/eu_directives/2003/discont1003.pdf) (the “October consultation document”), which consulted on the model discontinuation notice, the process for discontinuation and the appropriateness of discontinuing particular obligations including in respect of this particular market review.

3.8 At paragraph 13 of the October consultation document, the Director explained that Condition 43, which is a continued provision contained in Schedule 1 of BT’s Continuation Notice, has been continued in respect of BT. He stated that Condition 43 will be discontinued on a market by market basis. He also stated that where appropriate he will provide an indicative opinion on the services included in Condition 43 which are to be discontinued for the purposes of a particular market review (see below).

3.9 In so far as Conditions 57 and 58 are concerned, the Director set out at paragraph 11 of the October consultation document his view that that obligation only applies where certain obligations are in place, for example Condition 43. He therefore did not consider it necessary to discontinue Conditions 57 and 58 on a market-by-market basis since they will cease to apply when other obligations, such Condition 43, are discontinued, which will be on market by market basis. He proposed that Conditions 57 and 58 are discontinued formally once the whole market review process has been completed. The Director received no responses to the October consultation document which led him to change that view.

3.10 Some continued provisions in BT’s Continuation Notice relate to other market reviews. As market reviews are likely to be completed at different times, this raises an issue about when to give notice that a Continuation Notice ceases to have effect. Therefore, the Director has decided to discontinue continued licence conditions for the purposes of a particular market at the time when that market review is completed and any new obligations in that market are imposed. The other licence conditions in BT’s Continuation Notice will, however, continue to have effect through the Continuation Notice in relation to other markets, where the relevant review has not been completed because the Notice would only have ceased the Continuation Notices in part.

3.11 As stated in paragraph 3 to the Statement “Discontinuing Licence Conditions” published on 13 November 2003, the Director received three responses to that consultation, but none of the points raised were specific to the process of discontinuation of regulations relating to this market. The regulations to be
discontinued in this market therefore remain as set out in the Discontinuation statement.

The Discontinuation Notice

3.12 The Notice given under paragraph 9 (9) of Schedule 18 to the Act to discontinue Condition 43 is included at Annex D to this explanatory statement. The effect of the discontinuation Notice will be to discontinue the continued Condition 43, in so far as it applies to the market covered by this review.

3.13 The following is a non-exhaustive, indicative list of those services which the Director considers that Condition 43 will be discontinued in respect of, to the extent that they relate to this market review:

**BT Products**

1. **Wholesale Unmetered narrowband Internet termination**
   - SurfPort24
   - SurfPort Plus
   - SurfPort Extra
   - SurfNet

2. **Products which are included, in part, in the unmetered narrowband Internet termination market**
   - WebPort Elite
   - WebPort PAYG
   - WebPort 24
   - WebPort Complete Dial Access
   - Virtual ISP

The Notice is deemed to be effected a working day after its publication and posting. Therefore, in accordance with section 7 of the Interpretation Act 1978 and section 394 (7) of the Communications Act 2003, this Notice is deemed to be effected on 1 December 2003.
Annex A

NOTIFICATION PURSUANT TO SECTION 79 OF THE COMMUNICATIONS ACT 2003

The identification of a market, the making of a market power determination in relation to that market.

WHEREAS:

(i) the Director General of Telecommunications (the “Director”), in accordance with Regulation 6 of the Electronic Communications (Market Analysis) Regulations 2003, made a proposal for identifying a market and making a market power determination in relation to that market by publication of a notification on 14 March 2003 (‘the First Notification’);

(ii) however, in April 2003, the European Commission advised national regulatory authorities that such a notification could not be made under Article 7 of the Framework Directive (Directive 2002/21/EC) before 25 July 2003. In addition, the Electronic Communications (Market Analysis) Regulations 2003 were replaced by the Communications Act 2003 (the “Act”) on that date;

(iii) by virtue of the Communications Act 2003 (Commencement No. 1) Order 2003 (S.I. 2003/1900 (C.77)) made under sections 411 and 408 of the Act:

   a) certain provisions of the Act were commenced on 25 July 2003 for the purpose only of enabling the networks and services functions under those provisions to be carried out by the Director; and

   b) those provisions of the Act are to have effect as if references to Ofcom were references to the Director;

(iv) consequently, in accordance with section 80 of the Act, the Director made a proposal for identifying a market and making a market power determination in relation to that market by publication of a notification on 26 August 2003 (‘the Second Notification’);

(v) the Director invited representations about any of the proposals set out in the First and Second Notifications and the explanatory statement accompanying the First and Second Notifications by 30 May 2003 and 26 September 2003 respectively;

(vi) a copy of the Second Notification was sent to the Secretary of State in accordance with section 50(1)(a) of the Act, and to the European
Commission and to the regulatory authorities of every other member State in accordance with sections 50(3) and 81 of the Act;

(vii) by virtue of section 80(6) of the Act, the Director may give effect to any proposals to identify a market for the purposes of making a market power determination or any proposals for making a market power determination set out in the Second Notification, with or without modifications, where:

a) he has considered every representation about his proposals made to him within the period specified in the Second Notification;

b) he has had regard to every international obligation of the United Kingdom (if any) which has been notified to him for this purpose by the Secretary of State; but,

c) the Director’s power to give effect to such proposals is subject to section 82 and 83 of the Act;

(viii) the Director has considered every such representation made to him in respect of the First and Second Notifications and the accompanying consultation document; and the Secretary of State has not notified the Director of any international obligation of the United Kingdom for this purpose;

(ix) the European Commission has not made a notification for the purposes of Article 7(4) of the Framework Directive as referred to in section 82 of the Act and the proposal does not relate to a transnational market as referred to in section 83 of the Act;

THEREFORE

1. The Director General of Telecommunications (‘the Director’) in accordance with section 79 of the Act:

(a) identifies the following market for the purpose of making a market power determination:

the market for wholesale unmetered narrowband Internet termination for Internet traffic originating in the UK excluding the Hull area; and

b) makes the following market power determination in relation to the market referred to in paragraph 1(a) above:

no undertaking, either individually or jointly with others, has significant market power.

2. The effect of, and the Director’s reasons for identifying the market set out in paragraph 1 (a) above, is contained in Chapter 2 of the explanatory statement
with this notification (this 'Notification') and Chapter 2 and Annexes A and B of the explanatory statement accompanying the Second Notification.

3. The effect of, and the Director's reasons for making the market power determination in paragraph 1(b) above, is contained in Chapter 2 of the explanatory statement with this Notification and Chapter 3 and Annex C of the explanatory statement accompanying the Second Notification.

4. In making the decisions referred to in paragraph 1 above, the Director has taken due account of all applicable guidelines and recommendations which have been issued or made by the European Commission in pursuance of a Community instrument, and relate to market identification or analysis, as required by section 79 of the Act.

5. In making the decisions referred to in paragraph 1 above, the Director has considered and acted in accordance with the six Community requirements set out in section 4 of the Act.

6. The Director has sent a copy of this Notification to the Secretary of State in accordance with section 81 (1) of the Act and to the European Commission in accordance with section 81 (2) of the Act.

7. Save for the purposes of paragraph 1 (a) of this Notification and except as otherwise defined in this Notification, words or expressions used shall have the same meaning as in the Act.

8. In this Notification:

   (a)  "Hull area" means the area defined as the 'Licensed Area' in the licence granted on 30 November 1987 by the Secretary of State under section 7 of the Telecommunications Act 1984 to Kingston upon Hull City Council and Kingston Communications (Hull) plc.

   (b)  "United Kingdom" has the meaning given to it in the Interpretation Act 1978.
DAVID ALBERT EDMONDS
DIRECTOR GENERAL OF TELECOMMUNICATIONS

27 November 2003
Annex B

Representations received

Table B.1 Non confidential representations on August 2003 Notification & Explanatory Statement

<table>
<thead>
<tr>
<th>Consultation respondent</th>
<th>Oftel market definition proposal: for or against</th>
<th>Oftel SMP proposal: for or against overall conclusion</th>
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<td>BT</td>
<td>No comment</td>
<td>Agree</td>
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<tr>
<td>European Commission</td>
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</tr>
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<td>1 For 0 Against 1 No specific comment</td>
<td>1 For 0 Against 1 No specific comment</td>
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Oftel also received two confidential responses.
Annex C

Responses to comments on market definition

Retail market definition

C.1 Comments were received in relation to Oftel’s critical loss analysis, demand-side substitution, consumer reactions to a 10% price increase, and market definition in the absence of regulation.

Critical loss analysis

C.2 One respondent makes several comments on Oftel’s estimation of the critical loss factor:
- A wide range for the critical loss factor is not meaningful for market definition.
- The range is not weighted by probability analysis. The respondent advocates weighting each significant price point (between £13 and £17, the typical residential prices on offer) to reflect the number of consumers that are present at each price point. This would reduce the estimate range presented by Oftel and produce a robust result.
- Marginal costs facing the hypothetical monopolist would be lower than the range proposed by Oftel, since Oftel has essentially used costs which an ISP entering the market would face rather than those faced by the hypothetical monopolist.
- The sales and marketing savings will be less than those proposed by Oftel.
- The respondent concludes that a reasonable estimate for the critical value for residential consumers would be 12.9% to 16.7%.

C.3 As outlined in Annex A in the consultation document, estimation of the critical loss facing the hypothetical monopolist is based on a number of key assumptions, namely the initial price of the retail unmetered Internet product and the marginal cost saved per unit of volume increase facing the hypothetical monopolist. Oftel used market information to estimate the value of these inputs. As a result the range of estimates for the critical loss factor reflects the possible range for these inputs.

C.4 The initial price of the retail unmetered Internet product for residential consumers reflects the range of prices currently offered by suppliers of the retail product. These were outlined in Table 3 of Annex A in the consultation document. The business tariff reflected the average monthly price paid by SMEs, based on Oftel survey data.

C.5 The marginal cost estimate was based on the costs to a hypothetical monopolist of a port of an unmetered Internet termination and the contention ratio employed by the hypothetical monopolist. As noted in the consultation document Oftel has found that the cost of an unmetered Internet termination port varies
according to the number of ports purchased and the length of contract undertaken. Therefore a range of prices were used in the analysis. Finally on the basis of evidence from industry Oftel has assumed that contention ratios are 10:1 for residential services and 4:1 for business services.

C.6 On the basis of this it seems reasonable to Oftel to produce a range of estimates for the critical value facing a hypothetical monopolist. Oftel has not weighted the range of estimates because the results are simply interpreted as indicative of market boundaries. Oftel does not believe that weighting each significant price point between the current range of prices available to consumers would make the estimate of the critical value any more robust.

C.7 Oftel accepts that the appropriate marginal cost savings facing the hypothetical monopolist may be lower than that proposed in the consultation document. For the purposes of the consultation Oftel used market prices of a range of products available to service providers entering the market. However since the hypothetical monopolist would serve the whole market it seems likely that economies of scale could be achieved. Hence the marginal costs facing the hypothetical monopolist are likely to be lower than those facing an ISP. The respondent suggests that marginal costs would fall in the range of £45-55.

C.8 Using this range Oftel estimates critical values of 12% to 15% for residential users and 12% to 13% for business users.

C.9 Oftel's survey data showed that 7% of residential users of narrowband unmetered services claimed that they would switch to metered services as a result of a 10% price increase. 14% of business users of unmetered services would switch to metered services in response to a 10% price increase.

C.10 The residential results are clearly lower than the critical value estimates, although the business result appears to slightly exceed the critical value estimates.

C.11 The same survey showed that 14% of residential users of narrowband unmetered services would consider switching to broadband services (7% to lower speed and 7% to higher speed broadband internet access) as a result of a 10% price increase. 3% of business users of unmetered services would switch to broadband services in response to a 10% price increase.

C.12 The business result is substantially lower than the critical loss estimate although the residential result is not conclusive.

C.13 The revised critical loss estimates do not have a substantial impact on Oftel's conclusions. The only result to have changed (relative to the critical loss estimate) is the apparent substitutability between unmetered and metered Internet services for business users. However Oftel believes that the results are still consistent with a distinct unmetered Internet access market for the following reasons:
- The calculation is relatively conservative because Oftel's previous market research has found that fewer customers actually switch than claim they would switch services. Therefore the survey results are expected to be over-estimates of switching behaviour. Moreover the result is based on the assumption that all consumers would instantly switch whereas in reality they would switch over time.

- Oftel does not rely solely on the SSNIP test to define the market boundaries. They are used to complement consumer survey information on usage patterns and the reasons why consumers use particular packages, as set out in Annex A of the August consultation document.

**Demand-side substitution**

C.14 The Commission notes that “Oftel’s analysis of demand-side substitution would have been stronger had it been based on a broader empirical foundation, as there could be high churn rates between metered and unmetered services”.

C.15 Oftel did consider the degree of switching between metered and unmetered services in the consultation document (paragraph A.35), outlining the reason why churn rates are not useful indicators of demand side substitutability (paragraphs A.45-A.47). As a result Oftel used critical value estimates and survey evidence about willingness to switch to other services in response to price rises to inform the analysis of market boundaries. In addition Oftel considered survey evidence about the reasons why consumers use unmetered Internet services (paragraphs A.41 and A.56).

**Consumer reactions to a 10% price increase**

C.16 One respondent is critical of the way Oftel assesses whether a hypothetical monopolist can profitably increase prices, arguing that the correct approach is to consider the total number of people who would switch out of unmetered internet services, thereby placing a constraint on the pricing of the hypothetical monopolist. The respondent argues that this is the correct approach given that the hypothetical monopolist would be indifferent about where its customers switch and would only be concerned about whether or not the price rise were profitable. Rather than considering whether pairs of products are sufficiently good substitutes to be subject to a common pricing constraint, this would give an indication of whether the pricing behaviour the hypothetical monopolist is constrained by switching to all substitutes together.

C.17 In the August consultation document the potential for demand side substitution between unmetered and metered Internet use and unmetered Internet and broadband use is considered. Separate analyses are undertaken for business and residential use.
C.18 First the Director considered whether residential (and business) users of unmetered Internet services would consider switching to metered Internet use in response to a 10% price increase and then whether residential (and business) users of unmetered Internet services would consider switching to broadband services in response to a 10% price increase.

C.19 If the approach to the hypothetical monopolist test suggested by the respondent is applied to the survey evidence of consumer switching intentions then it might appear that unmetered narrowband services are not a separate market. However, Oftel believes that it would be wrong to place so great a weight on survey evidence of this nature because the level of claimed switching intentions is rarely achieved in practice. In addition, other evidence emphasises the importance to consumers of the qualitative differences between metered and unmetered narrowband and broadband services. Moreover, the markets for Internet access services are still evolving and liable to change over time.

C.21 One of the weaknesses of relying on the available empirical data to carry out the SSNIP test is that the markets for narrowband and broadband Internet access are still evolving and switching may reflect factors other than a pure price response by consumers. For example it is feasible that consumers have and will migrate from unmetered to broadband services as they become aware of the relatively new broadband services, attracted by the particular features of broadband services. Moreover it is likely that some will change their mind if, say, the specific features of broadband access do not suit them as well as initially thought.

C.22 As a result the analysis of market definition should consider other sources of evidence such as the features of unmetered and other forms of access valued by consumers, patterns of use and so on.

C.23 Oftel's definition of three separate markets, metered, unmetered and broadband services, reflects the different characteristics of the services and survey evidence which suggests that large numbers of consumers value the characteristics of these distinct services.

C.24 Oftel therefore believes that it should continue to define separate markets for metered and unmetered narrowband and for broadband services. The empirical evidence to support a wider market definition as proposed by the respondent is inconclusive. However, if the market were widened then the data would suggest that it would be broadened to include broadband services, i.e. the nearest demand side substitute. It is unlikely that a further SSNIP test on this wider market would suggest that it should be broadened to include metered internet access services. Thus, adopting the respondent's proposed approach might lead to broadband (but not metered narrowband) being considered in constraints on unmetered
narrowband\textsuperscript{1}. At this point, it is worth re-iterating that market definition is a means to an end, which is to assess the extent of competition in the relevant market. In the context of this market review the aim is to assess the need for regulation to protect consumers. Thus the key question for Oftel, if it adopted this wider market definition, would be whether there would be a high risk that consumers of unmetered narrowband services would not be adequately protected simply by the availability of broadband. Oftel believes that there would indeed be a high risk of this. This is particularly true given the fact that prices of broadband are not currently regulated. Therefore Oftel considers that, even if a wider market were defined, it would reach the same conclusions regarding remedies as with its preferred definition of separate markets.

\textit{Market definition in the absence of regulation}

C.25 One respondent argues that if retail markets were defined in the absence of wholesale regulation no unmetered retail product would exist and the natural conclusion would be that there would just be a narrowband Internet access market.

C.26 Oftel disagrees with this perspective. Oftel's analysis of markets is consistent with the existence of FRIACO because FRIACO regulation is imposed on the wholesale call origination market (in response to competitive conditions at this level) rather than at the wholesale Internet termination level. The principle of defining markets in the absence of wholesale regulation refers to wholesale regulation in the wholesale market being considered, i.e. in the absence of a wholesale unmetered termination product being available on regulated terms, rather than the absence of any wholesale market regulation at all. It does not preclude the supply of a wholesale unmetered narrowband Internet termination product by the hypothetical monopolist or the existence of an unmetered retail product.

\textit{Wholesale market definition}

C.27 One respondent argues that Oftel should not rigidly rely on the derived demand approach to inform wholesale market boundaries. Demand and supply-side substitutability at the wholesale level should also be considered in terms of the characteristics of the wholesale market. In addition the Commission noted that unmetered wholesale services, like FRIACO, could be used for retail services other than just unmetered Internet access.

C.28 Oftel outlined the logic behind the approach to market definition in paragraph A.41 of the consultation document.

\footnotetext{1}{Note that even if a wider market were adopted here, this would not necessarily mean that broadband services would be part of a wider market when considered from the perspective of Wholesale Broadband Access market review. The analytical question in that market review applies to switching behaviour of broadband consumers rather than switching behaviour of unmetered narrowband consumers. This issue will be considered in the Wholesale Broadband Market Review.}
C.29 Oftel accepts that unmetered wholesale services can in principle be used for a number of retail services. However, the effect of this on demand conditions at the wholesale level would still be considered in the context of looking at demand derived from the retail level. Moreover Oftel is not aware that this is currently widespread in the UK. As a result it is not expected that including the full range of uses of unmetered wholesale services would alter the analysis outlined in the consultation document dramatically.

C.30 In fact Oftel has effectively considered the extent of demand-side substitutability at the wholesale level by assessing the nature of supply-side substitutability at the retail level. In other words the two are equivalent. This follows since wholesale services are used to provide retail services. Hence the main driver of demand side substitutability at the wholesale level would be conditions at the retail level.

C.31 For example in order to consider whether demand for wholesale metered services would constrain the pricing behaviour of a hypothetical monopolist supplier of wholesale unmetered services it is necessary to consider the extent to which purchasers of wholesale unmetered services would switch to wholesale metered services in response to a price increase. If ISPs were able to substitute a metered wholesale product for an unmetered wholesale product in order to supply an unmetered retail product to consumers the pricing behaviour of the hypothetical monopolist at the wholesale level may be constrained. This was considered in the consultation document in terms of the extent to supply-side substitution at the retail level. In other words the extent to wholesale demand-side substitutability at the wholesale level depends on the nature of supply-side substitutability at the retail level. This was outlined in the consultation document in paragraphs A.59 to A.62.

C.32 Therefore, Oftel's derived demand approach is consistent with the observations made by the European Commission and the other respondent.
Annex D

Discontinuation Notice

NOTICE TO BRITISH TELECOMMUNICATIONS PLC UNDER PARAGRAPH 9 OF SCHEDULE 18 TO THE COMMUNICATIONS ACT 2003

Notice that certain continued provisions set out in the continuation notice given to British Telecommunications plc on 23 July 2003 will cease to have effect from 1 December 2003.

1. The Director General of Telecommunications (‘the Director’), in accordance with Paragraph 9(9) of Schedule 18 to the Communications Act 2003 (‘the Act’) hereby gives notice to British Telecommunications plc (‘BT’) that certain continued provisions contained in Schedule 1 to the continuation notice given to BT on 23 July 2003, which had effect from 25 July 2003, (‘the Continuation Notice’), will cease to have effect from 1 December 2003 to the extent set out in Schedule 1 to this notice (‘the Discontinued Provisions’).

2. In giving this notice, the Director has, in accordance with Paragraph 9 (11) of Schedule 18 to the Act, taken all steps necessary for enabling him to decide whether or not to set a condition under Chapter 1 of Part 2 of the Act for the purpose of replacing the continued provisions and whether or not to exercise his power to set a condition under that Chapter for that purpose.

3. All directions, determinations, consents and other provisions which were continued under the Continuation Notice by virtue of Paragraph 9(8) of Schedule 18 to the Act will also cease to have effect from 1 December 2003 to the extent that they were given or made for the purposes of the Discontinued Provisions.

4. To the extent that the Continuation Notice does not cease to have effect under Paragraph 1 of this notice, the Continuation Notice shall continue to have effect until the Director has given a further notice to BT in accordance with Paragraph 9(9) of Schedule 18 to the Act that it shall cease to have effect.

5. The Director issued a consultation as to his proposals to discontinue the Discontinued Provisions on 2 October 2003 and requested comments by 9 a.m. on 16 October 2003. The Director has taken into account the comments he received during that consultation.

6. In this notice, except as otherwise provided or unless the context otherwise requires, words or expressions shall have the meaning assigned to them and otherwise any word or expression shall have the same meaning as it has in the Act. For the purposes of interpreting this notice, headings and titles shall be disregarded.
DAVID ALBERT EDMONDS
DIRECTOR GENERAL OF TELECOMMUNICATIONS

27 December 2003
Schedule 1

The following continued provisions which were contained in Schedule 1 to the Continuation Notice will cease to have effect from 1 December 2003 to the extent set out below.

Condition 43 in so far as the condition relates to the market which has been reviewed in the wholesale unmetered narrowband Internet termination services - UK excluding Hull area market review ('the Market Review') and which the Director has decided not to set conditions to replace the continued provisions.