



**BT's response to Oftel's consultation document
"Review of the wholesale unmetered
narrowband Internet termination market"
issued on 17th March 2003**

30th May 2003

BT would welcome comments on this response. Comments should be addressed by email to Joanna Taylor at joanna.taylor@bt.com.

This is the non-confidential version of this response which will be made available electronically at <http://www.btplc.com/responses>.

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SECTION 1: EXECUTIVE SUMMARY

BT welcomes the opportunity to comment on Of tel's review of the Wholesale unmetered narrowband Internet termination market.

BT concurs with Of tel's analysis of the market as characterised by wide customer choice; recent market entry; the presence of countervailing buying power; increasing market share of major competitors to BT; and significant price reductions. These are clear indications that the market for wholesale, narrowband Internet termination is both dynamic and effectively competitive.

As outlined in BT's submission of January 2001 requesting regulatory relaxation for Dial IP services, our position has been that, following the launch of the FRIACO service, there has been no justification for *ex ante* regulation. BT entered the market for the provision of unmetered Internet termination behind other industry players and although for a period of time BT's market share rose substantially, this only reflected the commercial and technical risks taken by the company. These risks could equally have been taken by other industry players.

Since then, as Of tel notes, there has been further competitive entry and consequently BT feels justified in re-stating its stance of 2001, namely that there was, and currently is, no reason for *ex ante* regulation on BT.

This position is firmly held and would be appropriate under any conceivable market boundary definition. In particular, while we have not had sufficient time to research fully and confirm the proposal by Of tel for a separate retail market for unmetered rather than combined metered and unmetered narrowband services we do not believe the outcome would change this position. Nor, given this, have we been able to give full consideration to the issue of services in the 128-256kbit/s range; suffice it to say that these services put additional pressure on the provision of unmetered narrowband terminating traffic and there is the very high probability that there will be excess capacity forcing prices downward in the medium term.

BT's comments on SMP remedies are without prejudice to its position on the appropriateness or otherwise of any potential SMP designation. However, the evidence and analysis in this response would support the arguments which Of tel has put forward in favour of Option 1 under a finding of SMP, and we see little merit in the other Options.

NB. The original version of this response contained confidential information, which has been removed from this public version of the response.

SECTION 2: OVERVIEW

This section summarises BT's position with respect to market boundaries, market power and remedies. Further detail is contained in the responses to Oftel's Questions, given in Section 3.

BT notes that Oftel accepts that this market is outside the Commission's Recommendation and that the Commission will have to be consulted in accordance with the Article 7 process for any regulation to be permissible. BT would like to point out that the Commission did not ignore Internet termination in the Recommendation, but was rather of the view that it should not be susceptible to *ex ante* regulation. BT therefore believes that Oftel would have to demonstrate an overwhelming case to justify regulation of this form.

MARKET BOUNDARIES

Oftel has proposed that:

- a. There are three retail markets for internet access: metered narrowband, unmetered narrowband including 128k and 256k, and broadband services (following the broadband market review a broadband service is now defined as strictly above 256kbit/s).
- b. There are two separate markets respectively for wholesale supply of metered and unmetered Internet traffic.
- c. There are two geographically separate markets, namely the UK excluding Hull and Kingston-upon-Hull by itself.

Putting to one side the issue of broadband services and where the precise boundary should be drawn (if indeed such a boundary is meaningful at all), BT is of the view that there is rather greater movement at the retail level between metered and unmetered services than Oftel supposes. BT intends to provide more detailed evidence on this matter when responding to the broadband consultation. It is however commonly understood between BT and Oftel that market boundaries are not unique and to an extent can depend upon the precise starting point.¹

This being the case, BT is content for the purposes of this exercise to concentrate on unmetered traffic in order to calculate historic trends, but believes that on a proper forward-looking analysis, as mandated by the new regime, additional competitive pressure will arise from both metered narrowband services and unmetered services above 64kbit/s². Hence, looking forward, the market shares from the exclusion of these services will be overstated and general competitive pressures understated.

In addition, Oftel accepts that it has not been able to estimate the level of cable terminating traffic. Clearly retail Internet services are a very important

¹ Two factors which will affect a finding of market power/market boundary are the level of price increase and the time period under consideration.

² Note too that there are metered broadband services now being offered – see <http://www.metronet.co.uk/adsl/paygo>

component of the cable company portfolio and something which puts competitive pressure on equivalent retail – and wholesale – services over copper loops. This would have a major impact on the assessment of competition which has not been given sufficient consideration in BT's view.

BT accepts there are clear differences between Hull and the rest of the UK such as to make it a separate geographic market for the supply of both retail internet access and wholesale internet termination.

MARKET POWER

Oftel proposes that in the UK excluding Hull, no undertaking has SMP in the supply of wholesale unmetered or metered narrowband termination but that in Hull, Kingston Communications has SMP in the supply of narrowband Internet termination from traffic originated in Hull, derived from the absence of a FRIACO product.

BT agrees with Oftel's finding that no undertaking outside Hull has dominance in the supply of retail Internet access or wholesale Internet termination and broadly agrees with Oftel's findings in the UK market excluding Hull. However, BT has some issues with the calculation of market shares and the only limited degree to which the market analysis takes a forward-looking view.

In summary, BT is of the firm view that competitive conditions will intensify for a number of reasons including new capacity now available to meet ISPs' demands and from possible reductions in the size of the overall volumes of termination traffic.

PROPOSED REMEDIES IN EVENT OF SMP FINDING ON BT

BT is of the view that consideration needs to be given to the facility to use competition law instead of *ex ante* regulation. In BT's view, Oftel is fully capable of handling any issues of potential abuse of a dominant position under competition law. This would indicate that Option 1 rather than Oftel's preferred Option 2 would be appropriate.

Oftel notes that the processes of cost accounting and accounting separation are complex and are therefore subject to a separate consultation – "Financial reporting in SMP markets: A consultation on accounting separation and cost accounting systems" (the "Financial Reporting consultation").

In its consultation on the Wholesale Unmetered Narrowband Internet Termination Market, Oftel has made various observations on cost accounting and accounting separation. However, as stated above, BT is of the view that consideration needs to be given to the facility to use competition law instead of *ex ante* regulation. Therefore we do not believe any cost accounting or accounting separation obligations should be imposed in the Wholesale Unmetered Narrowband Internet Termination Market, even if BT was ultimately found to have SMP.

DRAFT TEXT OF SMP CONDITIONS RELATING TO KINGSTON-UPON-HULL

BT has no comments at this time regarding the draft text of the proposed SMP Conditions provided by Oftel. Our main concern is for the availability of a FRIACO product. BT reserves the right to submit comments on the Conditions separately, noting that Oftel would in any case need to go through the Article 7 consultation process before such Conditions became operable.

SECTION 3: RESPONSES TO OFTEL QUESTIONS

Question 1.1 Do you agree with Oftel's reasons for reviewing the wholesale unmetered narrowband Internet termination market?

BT is supportive of Oftel undertaking this review with the aim of removing legacy regulation which is not appropriate.

In the case of Kingston, BT maintains that regulation of narrowband terminating services alone will not be sufficient to deal with the competition issues which arise and these can only be addressed by the supply of a FRIACO type service in Hull (please refer to BT's response to question 6.1.)

Question 1.2 Do you agree that there is a greater concern over competitive conditions in the provision of unmetered compared to metered narrowband Internet termination?

BT's responses to Questions 3.3 – 3.6 below demonstrate that the competitive conditions for supply of terminating unmetered traffic are just as strong as for metered traffic.

As Oftel shows in the market analysis, since the introduction of FRIACO in May 2000, there has been increased market share in narrowband Internet termination taken by two OLOs and a third has entered the market. There has been significant network construction by a number of BT's competitors in the supply of unmetered narrowband Internet terminating services. [edited](#)

Oftel may have legitimate concerns regarding the opportunity for retail competition to develop in Hull given the lack of a wholesale unmetered call origination service. As stated above, it is BT's view that this would be rectified if a wholesale unmetered call origination service were to be offered by Kingston Communications.

Question 2.1 Do you agree that separate retail markets can be identified for metered and unmetered narrowband Internet access?

BT has not come to a definitive position on this issue since hitherto Oftel has identified a single market for these types of service, but preliminary evidence on consumer switching behaviour suggests that there is much more price-related movement than Oftel assumes between the two sets of services, which cannot be totally distinguished in practice given the various usage restrictions on unmetered services. The volumes of infra-marginal consumers and their price responsiveness are not the only variables which are relevant to the hypothetical monopolist test – of equal importance are price-cost margins. BT notes that there has been no discussion or analysis by Oftel of this issue in any of the Consultation Documents which cover retail Internet services. However, it has been considered - albeit in a limited manner - in the

broadband market review where Oftel estimated a number of critical loss volumes.

On the supply side, most ISPs offer both metered and unmetered services. Metered and unmetered narrowband access offer a similar customer experience in terms of network performance and functionality.

In summary, on the demand side BT is not sure about the market boundary but we are inclined to believe that the services are in a joint market. On the supply side, it is evident that the services should be in the same market.

Question 2.2 Do you agree that unmetered narrowband Internet access is in a separate market to broadband Internet access?

BT's position, as set out in the Supplementary Submission to Oftel on the draft ATM Direction in February 2002, was that retail broadband services were price constrained by narrowband services, but retail narrowband services comprised an economic market in their own right largely by force of the relative size of the number of infra and intra-marginal customers taking both sets of services and their likely responsiveness to price changes.

In that submission, BT did not further test whether the smallest possible economic market might consist of unmetered traffic alone, nor if metered traffic were abstracted, whether unmetered traffic (if not consisting of an economic market) could become one if broadband traffic was added.

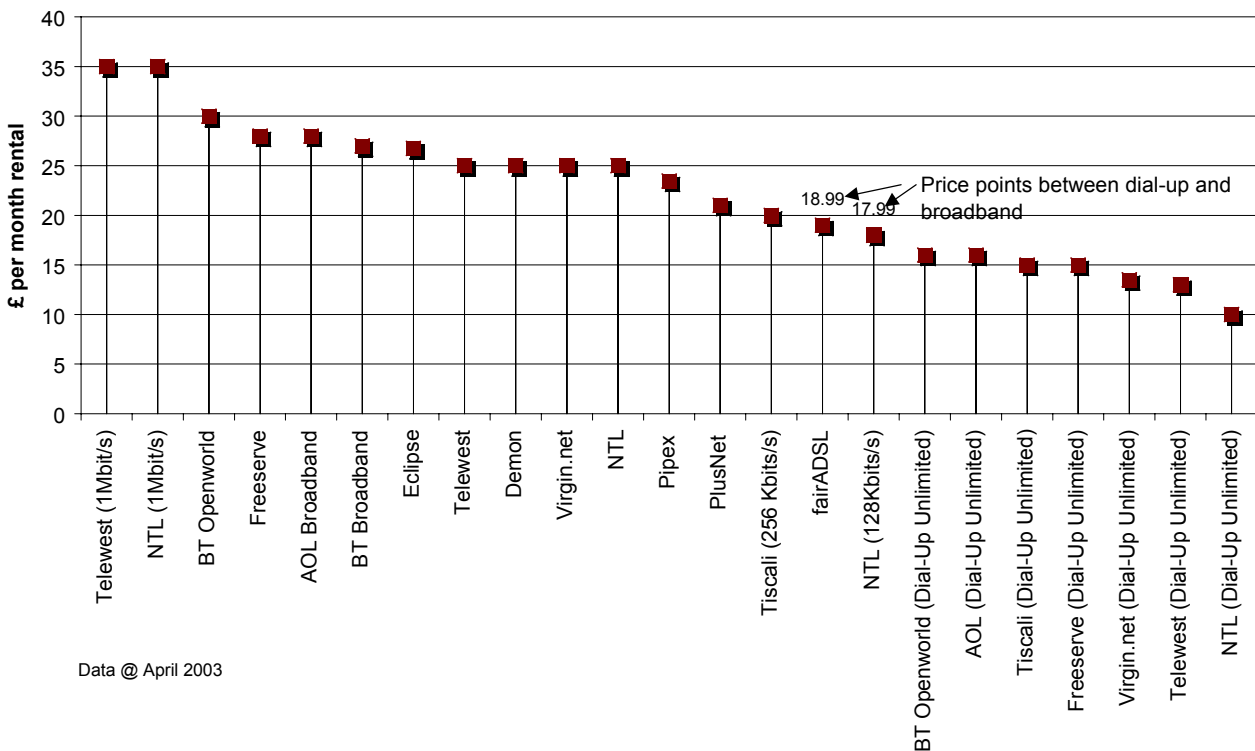
Without offering any objective justification using the sorts of statistical methods employed in the broadband study, our provisional position is that at the current point in time:

- It is unlikely that taken individually any of metered narrowband, unmetered narrowband and broadband services would constitute an economic market although arguments can be advanced for such a case.
- It is probable that the combination of the two narrowband services would constitute an economic market.
- It is unlikely that the combination of broadband and metered narrowband would constitute an economic market which could be meaningfully used in a market review.
- It is possible that the combination of unmetered narrowband and broadband services might constitute an economic market.
- It is very likely that the combination of the three sets of services would constitute an economic market, but this might not be the smallest unique economic market.

One way of interpreting the last conjecture is through a chain of substitution; however the Commission in its Guidelines makes clear (paragraph 60) that this needs to be substantiated given the possibility of unduly widening the scope of the relevant market.

Figure 1

Prices For Unmetered Narrowband And Broadband Retail Services



Data @ April 2003

Figure 1 above shows that there is a broad continuum of prices in the retail market moving from unmetered narrowband services to broadband services with no obvious break point. However, these prices do not conclusively demonstrate a chain of substitution but rather emphasise that the conditions for a chain could well be satisfied at some point in time.

The likely development of both broadband and narrowband services over the next few years will undoubtedly complicate this situation further. If broadband prices fall such that a high volume of narrowband customers shift to take this service and/or unmetered prices rise from current levels, then essentially one service ‘collapses’ into the market of the other service and the two ‘markets’ are indistinguishable. In such circumstances, unmetered Internet access becomes increasingly price constrained by broadband prices.

The role of ‘intermediate’ services between narrowband 64kbit/s and broadband (the latter as defined by OfTel of above 256kbit/s) may also play a role in establishing a chain of substitution between the two sets of services. Only time will tell whether sufficient infra-marginal customers will be prepared to switch between the services in question to bind them together into the same market.

The important regulatory implication of the above – and the series of related Questions which Of tel poses on market boundaries – is that any conclusions on market power (SMP) should be shown to be robust to plausible sensitivity testing of related market boundaries. BT does not feel that this has been done adequately either in this review or in the broadband market review.

Question 2.3 Do you agree that wholesale unmetered narrowband Internet termination is in a separate market to metered narrowband Internet termination?

On the demand side at the retail level BT has not come to a definitive conclusion regarding whether these services constitute part of the same market. On the supply side Of tel should note that given that a reasonably large number of OLOs have installed networks to take unmetered traffic off at the DLE layer, they have the same capacity in place to handle metered traffic. This would indicate that the two sets of services are in the same market.

Question 2.4 Do you agree that wholesale unmetered narrowband Internet termination is in a separate market to wholesale broadband access?

BT has had difficulty in answering this question, as it appears to confuse termination and access which are different elements in the supply of both narrowband and broadband services.

In the context of this review and subject to the caveats discussed above in the Overview, BT accepts that a preliminary assessment of competitive conditions for the termination of unmetered narrowband traffics could ignore broadband services but only for the examination of historic trends.

Looking forward, Of tel should take into consideration the additional constraints of services up to 256kbit/s (defined by Of tel as narrowband in the broadband review) and the possibility that broadband retail prices will be sufficiently close to narrowband prices to put additional pressure on unmetered retail and wholesale terminating prices.

Question 2.5 Do you agree that a separate geographic market can be identified for the termination of Internet calls that originate within the Hull area?

Yes, BT agrees with Of tel that a separate market for wholesale narrowband Internet termination exists for calls originating in the Hull area. The conditions of supply there are very different from those in the rest of the UK. This may also include its attractiveness to potential entrants.

Question 3.1 Do you think there are other criteria that are important for reaching a conclusion on SMP?

BT believes that the Consultation Document does not fully capture the competitive pressures which ISPs can exert on all suppliers, including BT. In many instances, ISPs tender for services on an infrequent basis; however their impact in the marketplace is profound. BT has had to adapt its portfolio in many ways which consideration of simple price trends would not necessarily capture. BT discuss this in greater detail in answer to Question 3.5 below.

BT believes the criteria set out by Ofel to assess SMP in this market review should be applied in a flexible but rigorous manner which is appropriate to the market in question. The criteria used are:

- market share;
- overall size of undertaking and access to capital markets
- countervailing buyer power;
- economies of scale;
- ease of market entry and potential competition;
- vertical integration;
- barriers to switching; and
- excess pricing & profitability.

BT has a number of reservations about some of these criteria e.g. size of undertaking is undefined and if it merely means turnover in the relevant services in question, it is synonymous with market share. Overall size of an undertaking does not confer market power as such, unless it is believed to be associated with ability to fund a programme of predation from deep pockets.

Similarly, access to capital markets seems to suggest that market power can be derived from some means of attracting capital which is independent of performance.

Economies of scale do not necessarily confer market power as they may be associated with sunk costs which tend, *ceteris paribus*, to be fixed and to lower market power.

BT suggests that these criteria should be analysed in a consistent fashion and not as a 'tick list' in which market power can be attributed if any of the criteria can be met in the absence of others which would corroborate the underlying hypothesis of how and why market power has been acquired. In the context of high prices and/or persistently high profitability, the latter need to take into account the full range of uncertainties in technical progress and the like where sunk costs have been incurred.

BT will provide further comments on the interpretation of market shares and profitability in its response to the broadband market review in due course.

Question 3.2 Do you agree with Oftel's analysis of the key criteria?

BT agrees with Oftel's conclusions from its analysis of the key criteria i.e. that there is no justification for the continuation of its current SMP obligations, although we have some reservations about the actual methodology used.

Question 3.3 Do you agree with the Director's initial view that there is no undertaking with SMP?

BT agrees with Oftel that no supplier of narrowband Internet termination in the UK market (with the exception of Hull), has SMP. The market is increasingly competitive, with pressures coming from both new entrants, broadband take-up and emerging excess capacity in narrowband Internet termination.

[\(edited\)](#)

Question 3.4 Do you agree with Oftel's assessment of collective dominance?

BT agrees with Oftel that there is not collective dominance. There is no evidence of terminating operators explicitly or implicitly colluding nor are the necessary conditions for such behaviour likely to be satisfied, as outlined in our responses to the Questions above.

Question 3.5 What impact do you think changes in the market will have on its future competitiveness?

As background to future competitiveness, BT would like to set out some historic context of service innovation which has been led by market conditions, and also an explanation of the impact and growth of countervailing buying power.

[\(edited\)](#)

The other key ISPs will continue to negotiate best price with alternate suppliers in the wake of AOL's multi-sourcing policy which has driven considerable platform expansion in the industry as a whole.

Changes may appear to be slow in this marketplace but are dramatic when they occur, supporting the claim that the market is in reality a very dynamic one.

Another source of future downward pricing pressure is the growing countervailing buyer power of ISPs. This is arising from both organic growth and is also driven by pricing, branding, service quality and acquisitions. Currently, the three major ISPs account for over half of the retail ISP customer

base. Their size, and the availability of choice of terminating operator through new entry, gives them considerable bargaining power.

(edited)

AOL multi-sources narrowband Internet termination capacity, purchasing from each of the suppliers. This has resulted in a considerable degree of influence over the overall behaviour of the market, and countervailing buyer power. As a result of the end-user client technology employed by AOL, they are able to move large volumes of end user traffic from one network provider to another over a very short period of time (as evidenced during the failure of Carrier1's business). Any operator losing large volumes of AOL traffic will inevitably then have surplus network capacity to offer to the market, possibly placing downward pressure on its termination prices to other ISPs.

Freeserve also negotiates for provision of service through a competitive tendering process.

The net result of these trends is that BT expects to see a continuing decline in its market share on both volume and revenue bases. Oftel has stated (in paragraph 3.5) that 'BT does not appear to charge a significant price premium compared to other operators', so the BT volume share should be similar to its market share by value.

(edited)

The growing power of ISPs will also stimulate future competition among narrowband Internet termination suppliers to secure and retain the biggest ISPs as clients.

Question 3.6 Do you believe that the competitive conditions in this market will change over the next two years?

See answer to Question 3.5 above. Over the next two years, competitive conditions for suppliers of narrowband Internet termination can be expected to become even more challenging as outlined above. Suppliers will be competing to service a market that will not be growing as in the past. Customer switching to higher bandwidth services is expected to continue, sustaining high growth rates for these services and promoting greater flexibility in unmetered narrowband Internet termination contract terms. Broadband prices at the wholesale level are generally declining, exerting downward pressure on unmetered narrowband Internet termination prices and countervailing buyer power is increasing as competition and consolidation among ISPs focuses customer numbers among fewer suppliers.

Question 4.1 Do you have any comments on the range of options that Oftel is proposing?

Oftel puts forward a range of regulatory remedies in the event that there is a finding on SMP. As explained elsewhere, we do not believe that any SMP exists in this market, other than in the Kingston area. No regulation is necessary outside that area. The option that Oftel would prefer if there is to be regulation is Option 2 - a requirement for BT to publish prices for services supplied to itself.

This is one mechanism of achieving transparency, but it may have a counter-intuitive effect. Transparency is, as Oftel accepts, a double-edged sword and we would refer Oftel to our previous submissions in this area³.

For a market as dynamic as the one Oftel describes, this requirement would appear to be inconsistent with the aim of the review, which is to take a fresh view of regulation and encourage the development of retail markets. It would have the impact of stifling the very innovation that Oftel is seeking as a feature of this market.

Question 4.2 Are there any additional advantages or disadvantages of the options that Oftel has not considered?

BT would be most concerned that under Options 2, 3 or 4, BT Openworld would be placed at a disadvantage compared to other ISPs.

Oftel stated in its March 2003 review of the Internet Market that 'The UK has a competitive dial-up ISP market with both pay-as-you-go and unregulated packages available to consumers. Unlike much of the rest of Europe (including Germany and France), an offshoot of the incumbent telecoms operator does not dominate the UK dial-up retail market.'

On this basis there is no justification for imposing additional *ex ante* regulation beyond even that which exists at the moment. At present, BT Openworld purchases narrowband termination products at prices which are published in the BT price list. The price list is tiered to reflect volume discounts but there is no means of identifying the volume at which BT Openworld is buying.

However Option 2 proposes that price data be published which will enable other ISPs to identify the exact price at which BT Openworld is purchasing capacity. Also, depending on Oftel's precise publication requirements, it might be possible for competitors to determine the volume of ports purchased and therefore BT's network growth or reduction position. With a view of BT Openworld's purchasing price and volumes, other ISPs would be in a better position to negotiate more favourable deals with BT Openworld's suppliers and therefore potentially reduce costs of a major input. This would distort the marketplace. In addition, we consider that Options 2-4 would not be

³ BT's regulatory obligations to provide advance notification of price changes & to maintain a published price list" October 2001.

conducive to innovation. Option 3 would particularly discriminate against BT Openworld by virtue of any ISP innovation having to be made available to all other ISPs.

Question 4.3 Do you agree with the Director's initial conclusion on the appropriate regulatory option (if SMP is found)?

No, BT does not agree with Ofcom's proposed regulatory solution should SMP be found.

Under the new Directives, SMP obligations must be based on the nature of specific competition problems identified in a market. In considering remedies in markets found not to be effectively competitive, therefore, NRAs must define the problems to be addressed so that any proposed obligations can be designed to tackle them. The duty on NRAs to impose only obligations which meet identifiable concerns means that concerns have to be well founded, with sufficient evidence to support intervention. There is no justification in the new framework for 'just in case' regulation.

ANNEX 1

**RESPONSE TO OFTEL'S ASSESSMENT OF COMPETITION FOR
WHOLESALE NARROWBAND INTERNET TERMINATION IN HULL**

Q5.1 Do you think there are other criteria that are important for reaching a conclusion on SMP?

See the answer to Question 3.1

Q 5.2 Do you agree with Oftel's analysis of the key criteria?

We agree with Oftel's assessment of SMP in the Kingston area.

Q 5.3 Do you agree with the Director's initial view that Kingston has SMP?

Yes, given the lack of competition in supply to the retail consumer of unmetered internet access and the lack of a FRIACO offering in the Hull area, we believe there is a need for action to be taken to encourage innovation in the Hull geographic market.

Q 6.1 Do you have any comments on the range of options that Oftel is proposing?

As Oftel has indicated, competitive conditions in the downstream termination market are heavily dependent on Operators having access to adequate unmetered call origination products such as FRIACO. In its "Review of the fixed narrowband wholesale access, call origination, conveyance and transit market" (Chapter 15), Oftel highlights the "availability of FRIACO products as an important consideration when assessing competition" in the narrowband unmetered termination market.

Indeed, Oftel goes on to state that 'the arguments in favour of a FRIACO product in the Hull Area are broadly similar to those outlined for the rest of the UK i.e. the promotion of competition in the downstream markets for retail unmetered narrowband internet access and wholesale unmetered narrowband termination'. BT agrees with this assessment. Given the above, BT believes that an obligation should be placed upon Kingston Communications to supply a FRIACO product as part of its Reference Offer.

Q6.2 Do you think the current terms and conditions of the Hullport24 product are fair and reasonable, if not, why?

Following enquiries to Kingston Communications, it appears that commercial terms and conditions for Hullport24 are not yet available and it is therefore,

not possible for BT to make any comment. However, from the service description which has been passed to BT, it is not clear that this product will meet the needs of ISPs. To bring real benefits to ISPs and consumers, Kingston Communications should be required to offer a FRIACO product, thus enabling other operators to integrate unmetered access from Hull into their national coverage-based services.

Q6.3 Are there any additional advantages or disadvantages of the options that OfTel has considered?

BT has no further comments concerning the provision of wholesale unmetered narrowband internet access in the Hull Area. However, BT would like OfTel to consider the wider issue of competitive wholesale unmetered internet access in areas served by cable television operators.

In order to bring genuine competition and choice to consumers who take basic telephony services from operators of alternative access networks, BT believes that those operators should be required to provide a wholesale unmetered narrowband interconnection products on terms compatible with BT's FRIACO product. This would give consumers the ability to choose which ISP they want to provide their retail unmetered internet access service, the same choice which is currently enjoyed by customers of BT.

BT investigated the availability of a wholesale unmetered narrowband internet termination product from other operators in 2002 and opened informal discussions with Kingston, NTL and Telewest. Regrettably these proposals were unable to progress much beyond the preliminary stage due to either an absence of a wholesale offering, or one that was not truly a wholesale offering e.g. HullPort24 which made the economic collection of such traffic unviable.

Q6.4 Do you agree with the Director's initial conclusion on the appropriate regulatory option, and that each of the conditions are appropriate?

BT agrees that OfTel's conclusion goes some way to addressing the lack of competition in the Hull area. However, BT would refer OfTel to its response to Question 6.1 above.
