BT Group plc's response to Ofcom's Consultation

of 19 June 2014

"*Fixed Access Market Reviews: Approach to the VULA margin*"

Non Confidential Version

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1. Executive Summary

The key issue in this Consultation

1.1 BT already faces strict constraints on its commercial freedom to set the VULA margin. These constraints include competition law and existing significant market power ("**SMP**") obligations imposed by Ofcom, which ensure that BT supplies VULA on fair, reasonable and non-discriminatory ("**FRAND**") terms, conditions and charges, and on Equivalence of Inputs ("**EoI**") terms, to all operators. The key issue for consideration in Ofcom's consultation on the approach to the VULA margin (the **"Consultation**") is, therefore, whether Ofcom has justified its proposal to impose a new, additional SMP condition on BT. BT submits that it has not.

1.2 As we show in this response, Ofcom's proposals are based on an erroneous view that an additional SMP remedy is required now as a preventative measure, not because of concerns that there is any distortion to competition happening now, but because there might be a risk over the period of this market review or beyond. Ofcom exacerbates this error by proposing that its aim should be achieved by enabling "*an operator that has slightly higher costs than BT (or some other slight commercial drawback relative to BT) to profitably match BT's retail superfast broadband offers*." This is despite Ofcom's admission that it has not compared other operators' overall costs with those of BT, as well as submissions by a number of stakeholders, including Sky and Virgin Media ("**Virgin**"), that BT's main competitors are likely to have their own cost advantages. It also stands in stark contrast to the growing range of profitable superfast broadband ("**SFBB**") offers being made by BT's competitors in this segment of the retail broadband market.

1.3 Ofcom's proposal would introduce a 'bright line' test requiring that a minimum margin is maintained across all BT's SFBB offers, including bundles with BT TV and/or BT Sport. BT would pass or fail the test purely 'on the numbers' and there would be no subsequent effects-based assessment of actual or likely harm. But, in constructing the test with the aim of ensuring competitors can profitably match BT's offers, Ofcom is proposing not only to make adjustments to BT's costs to meet the objective described above, but also to take an entirely static view of BT's margin at the point at which customers are acquired. While Ofcom acknowledges that acquired customers will be retained for a number of years, no longer term view of profitability is taken.

1.4 Such a static approach is inappropriate in a competitive and dynamic retail broadband market characterised by large and well-resourced competitors pursuing different strategies to acquire customers through a range of highly differentiated offers. BT's competitors will be investing, innovating and setting prices across their standard and SFBB offers with a forward-looking view of costs and revenues, and a more dynamic view of the value of acquiring customers. BT should not be constrained to make its commercial decisions – including to invest in BT TV and BT Sport – on a strictly static view baked into a 'bright line' test within an SMP condition.

1.5 The effect of Ofcom's proposed approach to assessing BT's margin at the point of acquisition is that rather than simply being able to profitably match BT's offers, competitors would actually be provided with unnecessary and unwarranted margin (or 'headroom') on SFBB services when competing against BT. Rather than promoting competition in the provision of SFBB services to the long term benefit of consumers, Ofcom's approach would more likely dilute the effectiveness of competition by providing a protective regulatory pricing 'umbrella' under which BT's competitors could seek shelter – i.e. competitors would be able to compete with BT at higher SFBB prices than necessary to acquire customers profitably. This would result in static and dynamic inefficiency in the broadband market.

1.6 Ofcom's proposals therefore amount to a regulatory windfall gain for BT's competitors. This would create an adverse regulatory distortion of competition across both SFBB and SBB and also across separate pay TV markets, to the detriment of consumers.

1.7 Contrary to the provisional conclusions in the Consultation, BT considers that Ofcom has misapplied the relevant legal framework, in that Ofcom has not passed the necessary jurisdictional threshold to impose an ex ante VULA margin squeeze test ("**MST**")[1]. In any event, its proposed MST is disproportionate because: (a) it does not satisfy the principle of proportionality or the requirements of the Communications Act 2003 ("**CA03**"), and (b) Ofcom has not shown that the MST is necessary, nor has it set the test so as to be the least onerous to achieve the regulatory objective.

1.8 In particular, BT considers that Ofcom has:

(a) failed to conduct a full and complete market analysis, and therefore misunderstood the nature of competition across broadband services, in particular the level of current and prospective competition in SFBB;

(b) not considered properly the effectiveness of existing SMP remedies and competition law in addressing the risk that BT could distort competition;

(c) failed to recognise fully and properly that the costs of Ofcom's proposals would increase the VULA margin and in effect provide a transfer from BT to its large and well-resourced competitors which would amount to an unjustified regulatory windfall;

(d) proposed a bright line test that has no effects-based analysis of whether BT's SFBB pricing distorts competition in the way Ofcom fears;

(e) compounded these flaws by proposing to include SFBB bundles with BT TV and/or BT Sport within the scope of the test in a highly static manner that is inconsistent with the intended long term strategic nature of the investments BT has made, and ignores the significant advantages enjoyed by Sky and other competitors in providing pay TV services and access to content; and

(f) proposed an MST which is inconsistent with the relevant EU Recommendations and out of kilter with the approach taken by NRAs in other EU Member States, especially in respect of the proposed adjusted Equally Efficient Operator ("**EEO**") approach, the inclusion of BT TV and Sport, the

[1] For convenience, in the remainder of this Response and depending on the context, BT uses the term "MST" to describe both ex ante margin squeeze testing in general, as well as the specific form of margin squeeze test proposed by Ofcom in the Consultation.

static nature of the proposed test and the failure to have any effects-based assessment.

The relevant market context: a competitive broadband market with different operators pursuing different strategies for SFBB

1.9 A key issue highlighted in this Response is that Ofcom has not carried out sufficient market analysis as to whether there is a risk of harm from BT margin squeezing, in particular given the existence of the current regulatory and legal constraints noted above.

1.10 The evidence presented in this Response shows that the broadband market, and within that market the supply of SFBB, is highly competitive and will remain so during the market review period. Actual and prospective SFBB consumers are served by a number of large well-resourced companies with differing commercial strategies and incentives. BT's more complete market analysis, relying on this evidence, demonstrates that (i) BT is not currently engaging in a margin squeeze and (ii) it does not have the ability and incentive to do so during the current market review period, especially given the existing legal, regulatory and market constraints BT faces.

1.11 Importantly, Ofcom has reached the wrong conclusion on the critical question of whether there is any actual or potential competition problem. It has instead concluded that the current and forecast numbers of connections suggest that there is the potential for a competition problem, rather than that fibre volumes simply reflect the commercial choices taken by Communications Providers ("**CPs**") to date about the timing and extent to which they seek to actively promote SFBB offerings.

1.12 With regard to the current situation, Ofcom's analysis is flawed because it has had insufficient regard to the facts that, for example:

(a) On the one hand, BT's strategy has been actively to upgrade its base to fibre, a strategy which has been equally available since 2010 to all CPs given the availability of VULA on EoI terms. Similarly, in line with its own strategic incentives, Openreach has attempted to drive fibre take up by all CPs. Virgin's broadband strategy has also been to upgrade its customer base to high speed broadband.

(b) On the other hand and in stark contrast to BT and Virgin, TalkTalk ("**TTG**") and Sky started promoting SFBB slowly, choosing instead to maintain a significant focus on copper broadband, in accordance with their own commercial priorities. Nevertheless, TTG and Sky are now promoting SFBB services 'above the line' and at a discount to BT's headline price while still, according to statements to the City, making a profit. There is not, therefore, any evidence that Sky or TTG need Ofcom's assistance in order to compete effectively.

1.13 Similarly, Ofcom's conclusions on the future are flawed. Current SFBB take-up rates (and BT forecasts made at a point in time) are not demonstrative of any competition problem. In fact, BT's share of net additions is already falling and this trend is likely to continue for a number of reasons. For example, Openreach has taken active steps to drive fibre adoption among all CPs and, as a result, CPs are increasingly offering compelling, profitable fibre offerings. Moreover and regardless of any changes in commercial strategy, other CPs are now at a cost advantage regarding fibre vis-à-vis BT, due to technological developments, such as the availability of self-install, and recent Ofcom regulation, such as the reduction in SFBB migration charges and minimum terms. In addition to these developments downstream, growing infrastructure investments upstream will also lead to greater retail competition. There is therefore nothing to suggest that Ofcom should act now, rather than potentially at a later stage if needed.

1.14 Considering these factors, the correct conclusion that Ofcom should have drawn is that, rather than diminishing, competition for fibre broadband is set to increase rapidly over the current market review period.

1.15 In addition to Ofcom's flawed analysis of broadband competition, Ofcom has also undertaken a flawed analysis of triple-play bundles and BT Sport. Ofcom's decision that its proposed MST should include BT TV and/or BT Sport does not consider properly the impact of the ability of CPs to offer differentiated triple-play bundles (including pay TV services and access to a range of content) on broadband competition. As such, Ofcom has failed to consider the relative strengths of BT's competitors in offering such propositions and the underlying commercial context in which BT is itself choosing to invest in BT TV and in BT Sport. Ofcom's overly simplistic and unsubstantiated conclusions lead it to include triple-play bundles and BT Sport within the MST in the overly crude and static form set out in the Consultation.

As a result of its flawed market analysis, Ofcom is proposing unduly to constrain BT's freedom to compete on the merits in supplying SFBB offers

1.16 Ofcom's limited analysis of the market results in it overstating the risk and potential impact of BT distorting competition by adopting margin squeeze strategies. Ofcom then proposes to place unnecessary constraints on BT's price setting over and above those contained within existing SMP remedies and competition law. BT is already subject to SMP obligations which ensure that it supplies VULA on FRAND terms, conditions and charges, and EoI terms to all operators. BT should therefore be allowed to compete on the merits in downstream markets by investing and innovating in pursuit of its legitimate strategic objectives.

1.17 By proposing a 'bright line' test based on a static view of costs and revenues, Ofcom is implementing a crude test that will prevent BT from competing on the merits with its competitors. The test risks prohibiting pro-competitive pricing by BT and handing an unwarranted and unnecessary leg-up to BT's competitors. These risks are amplified by the proposed approach to BT TV and BT Sport within the test, given the nature of these services and BT's objective of investing to drive long term growth. Ofcom's static tests of cost recovery imposed now will hamper BT's ambitions and reinforce existing asymmetries.

❖ **Focus: Ofcom's proposed treatment of BT Sport in the MST**
• The flaws in the proposed MST are most clearly exposed by (though not limited to) the specific proposals around the treatment of the provision of BT Sport channels to BT's SFBB customers. • In particular, Ofcom gives no consideration to the range of valuations different SFBB customers may place on the provision of the BT Sport channels as part of their package. The enclosed paper from Compass Lexecon assesses the specific issues raised by the inclusion of BT Sport within the MST and identifies the significance of valuation to any inferences that Ofcom may make about the risk of market exclusion and distortion. That paper indicates that Ofcom's approach to including BT Sport may, on its own, require BT to earn margin each year of around £100m in excess of the level actually required to ensure competition was not distorted. • In focusing on cost recovery in relation to BT Sport, Ofcom proposes to set BT's monthly margin requirement for acquired SFBB customers by, among other things, unitising the significant fixed – i.e. volume independent – costs of sports rights in a way that: (i) gives no regard to BT's position as an entrant in the provision of sports rights and that it will inevitably face a delay in making investments that form part of an intended longer term strategy profitable; and (ii) gives no regard to the fact that any value from rights will be extracted in a non-uniform way across the rights period, as BT has needed to grow its customer base from scratch, and because demand will reflect seasonality and the specific content being offered at specific points in time. • Ofcom essentially proposes to treat the costs of providing BT Sport as if they were simply an ongoing expense (or even a 'voucher') associated with BT's provision of SFBB, rather than a strategic investment in providing a new service into a different market. To the extent that BT's competitors choose to compete directly in relation to sports content, they would not assess this investment in such a constrained way when considering how to set prices and extract value from the investment over the longer term. • In short, the consequence of the flaws identified above is that the application of Ofcom's proposed MST is highly likely to result in the condemnation of behaviour that is economically rational and not in any way likely to harm competition in SFBB. Rather, Ofcom's MST may in fact distort competition in SFBB by providing unfair and unnecessary benefits to BT's competitors, with the risk of increasing prices, attracting inefficient downstream entry and deterring upstream investment.

1.18 BT has also identified flaws in the way Ofcom proposes to implement its static approach. The current set of proposals understate the average customer life ("**ACL**") and overstate the costs of network bandwidth required to support SFBB services such that, if retained within the MST, BT would be required to make an excess £[ ] per month of margin across all subscribers – i.e. margin above the level at which, even under Ofcom's flawed static approach, BT's competitors would be able to compete effectively. CONFIDENTIAL

1.19 The detrimental impact of these proposals on consumers would be significant. Placing a requirement on BT to maintain an overstated level of margin – i.e. above the level at which competition would actually be excluded – will have a dilutive effect on competitive pressures in the broadband market precisely because it offers unwarranted protection to BT's competitors. BT estimates that the identified flaws in Ofcom's static model could alone result in SFBB prices over £150m above the level required to support competition in the final year of this market review period alone. In reality, that figure could be even higher once the additional impacts from constraining BT's ability to price in a more dynamic way and from restricting the way BT can recover common costs from across different broadband customers are factored in. Furthermore, the Compass Lexecon report identifies that Ofcom's proposals would require BT to maintain margin to cover the estimated net cost of BT Sport even though this is not necessary to ensure competitors can reach minimum efficient scale and compete effectively for SFBB services. If Ofcom nevertheless required BT to maintain margin on SFBB services to cover Ofcom's current estimates of net costs of BT Sport [ ] then consumer prices could be further CONFIDENTIAL inflated in the final year of the current market review period by £350-400m.

1.20 With BT constrained to set prices to maintain this restrictive and unjustified level of margin, BT's competitors could either choose to pocket the excess margin they would make when competing against BT's prices or they could inefficiently and unfairly undercut BT to win increased market share with short and long term implications for the effectiveness of competition. At the same time, BT's incentives to make strategic investments to increase the value of its propositions and longer term competitive position would be undermined by the need to set current prices in the way proposed by Ofcom. Ofcom's proposed MST would therefore result in a loss of both static and dynamic efficiency, causing consumer harm, both in the short and long run.

1.21 Moreover, Ofcom's proposed MST in essence imposes on BT Consumer a form of 'double jeopardy'. If, as is currently the case, BT competes fairly and successfully for SFBB customers, Ofcom argues that this justifies a very conservative form of margin squeeze test without any effects-based analysis into whether that outcome is based on any underlying competition concerns. Conversely, if BT Consumer fails to establish a sufficiently large customer base, it will be unable to recover the net cost of BT Sport, thereby failing Ofcom's MST.

BT's proposed way forward

1.22 In this Response, we set out a more detailed and evidence-based assessment of competition in the broadband market. This assessment helps show how Ofcom's proposal is not compatible with its legal obligations, and is intended to help inform Ofcom's next steps in this matter.

1.23 BT considers that were Ofcom to carry out an appropriately full analysis it would conclude <u>at most</u> that:

(a) To the extent that Ofcom demonstrates an MST of some sort is required and is able to justify its imposition, a more targeted <u>unadjusted MST exclusively targeted on dual play propositions without BT Sport</u> would be a proportionate means to address the core vertical market entry problem that <u>could</u> arise as a result of BT's SMP in the Wholesale Local Access ("**WLA**") market.

(b) Ofcom would in any event need to adopt a more forward looking MST reflecting the realities of market dynamics. BT's main competitors are active across SBB and SFBB services, meaning Ofcom should also make the following adjustments to the MST:

(i) Capture the ACL for BT's SFBB customers, which is longer than the period assumed by Ofcom;

(ii) Reflect BT's true costs of bandwidth; and

(iii) Allow flexibility to recover fixed and common SG&A costs across SBB and SFBB customers.

1.24 BT's clear position – supported by evidence – is that, if Ofcom undertakes a proper market analysis, it should at that stage conclude that it is not appropriate to include BT Sport and TV within the scope of a formulaic, bright line MST which fails to involve any assessment of potential harm. In relation to any potential concerns regarding the impact of BT's supply of BT Sport and/or pay TV on SFBB, competition law is both a sufficient and more appropriate basis for addressing a broadband retail market with large, well-resourced competitors supplying heterogeneous bundles to address a diverse range of tastes and differing valuations on specific content.

1.25 In conclusion, BT submits that Ofcom has failed to justify (at all and/or in the form proposed) the imposition of a new SMP service condition 14, set out in Annex 5 to the Consultation, together with the associated guidance. A fuller analysis demonstrates that the existing constraints which BT faces (notably, its obligation to supply VULA on FRAND terms, conditions and charges, EoI terms and competition law) are sufficient to achieve Ofcom's aim of preventing competitive distortion, at least for the purposes of the current market review period. If, notwithstanding BT's submissions, Ofcom is still minded to proceed to introduce an MST, it must carry out further analysis and re-consult on its provisional conclusions.

2. Introduction

Establishing the key issue in this Consultation

2.1 In this Consultation, Ofcom proposes to implement a new, additional SMP remedy – over and above those imposed at the conclusion of the 2014 Fixed Access Market Review ("**FAMR**")[2] – to "*ensure that BT cannot use its SMP in the WLA market to set the VULA margin over the period of the market review such that it causes retail competition in superfast broadband to be distorted*".

2.2 In this Response BT does not seek to challenge in this Response:

(a) the finding in the FAMR that BT has SMP in the WLA market[3];

(b) the imposition of the other SMP remedies applying to the provision of VULA as set out in the FAMR, including the requirement to supply VULA on FRAND terms and conditions, and on an EoI basis;

(c) the generally expressed, conceptual margin squeeze paradigm under which a vertically integrated undertaking with SMP/dominance in an upstream market could adopt pricing strategies that foreclose the ability of others to compete effectively on related downstream markets on which the undertaking is active; or

(d) Ofcom's overall aim in the Consultation to ensure BT does not abuse its SMP in the upstream access market so as to distort SFBB competition.

2.3 However, BT submits that the existing suite of legal and regulatory remedies available to Ofcom – i.e. competition law and the SMP remedies detailed above – is more than sufficient to address any concerns related to the risk of exclusionary margin squeeze strategies that could, in theory, emerge.

2.4 The key issue for BT in the Consultation is whether Ofcom has demonstrated, on the basis of strong and compelling evidence that withstands rigorous scrutiny, (a) that a new additional SMP remedy is required and, if so, (b) that the proposed form of remedy proposed represents an appropriate, necessary and proportionate measure, taking account of:

(a) the relevant market context in which competition for SFBB services – which include services based on Openreach's supply of Generic Ethernet Access ("**GEA**") – is taking place now and is expected to take place during this market review period;

(b) the actual (rather than the purely theoretical) risk of BT adopting pricing strategies that could foreclose competition and the potential impact on consumers;

(c) the full range of options available to Ofcom to address any appropriately identified risks, including, the existing legal and regulatory remedies already

[2] See Ofcom, *Fixed access market reviews: wholesale local access, wholesale fixed analogue exchange lines, ISDN2 and ISDN30*, Statement, 26 June 2014.
[3] BT also agrees that there has been no material change since Ofcom concluded that market review.

at Ofcom's disposal and different forms of new additional remedies to that proposed in the Consultation; and

(d) the potential impact implementing those options may have (i) on competition and prices across any relevant markets, (ii) on the investments that BT has made and expects to make to support its propositions and (iii) on consumers of communications services.

2.5 BT considers that Ofcom has not undertaken an adequate analysis to justify the imposition of a margin squeeze test and, moreover, that, were Ofcom to conduct such an analysis, it would conclude that the MST proposed is not proportionate.

Introductory comments on margin squeeze concerns

2.6 It is clearly important in considering the key issue in the Consultation to establish the 'in principle' conceptual concerns relating to price/margin squeeze strategies that arise where a vertically integrated downstream player has dominance in supply of an upstream input.

2.7 Ofcom sets out at Figure 5.1 a standard illustrative example of how a conceptual price squeeze could operate and goes on to set out in simple algebraic terms the high level 'imputation test' that would indicate – subject to the crucial issues relating to how each of the cost and revenue figures would actually be populated – the margin available to an SMP/dominant undertaking's competitors.

2.8 However, presenting the issue in this simplified, illustrative way should not distract from what is the central issue at the heart of price/margin squeeze concerns: i.e. that consumers may suffer because downstream competition might be distorted due to foreclosure of efficient competitors.

2.9 The economics underpinning price/margin squeeze under competition law clearly establishes that an abusive price/margin squeeze requires not only a finding of insufficient margin (or 'profit sacrifice' by the dominant undertaking in the downstream market) under any imputation test, but evidence that this is capable of leading to exclusion from, or marginalisation in, the market.

2.10 It is only under certain conditions that, of itself, a finding of profit sacrifice under an appropriately structured imputation test might be said to demonstrate likely downstream exclusion/marginalisation and distortive effects. The so-called 'plain vanilla' case is where the following conditions apply:

(a) one key input, supplied by one dominant upstream company;

(b) downstream firms – including the dominant upstream company – competing in the supply of homogeneous products;

(c) rival downstream firms not having significant advantages relative to the downstream division of the dominant company; and

(d) historically known, or a combination of historically known and reasonably predictable, costs and revenues.

2.11 The focus of Ofcom's analysis of the issues in this Consultation is on the specific provision of SFBB services (offered over fibre) in a wider broadband market that also includes standard broadband ("**SBB**") services (offered over copper access technology). Moreover, as Ofcom acknowledges, SFBB and SBB services are increasingly provided in a range of bundled propositions reflecting:

(a) the diverse nature of demand for the underlying broadband service in which different customers will place different values on headline speeds, contention, usage limits, reliability, service, associated hardware and software, etc.; and

(b) the different values customers will place on the range of services offered by different suppliers in dual-play and/or triple-play bundles – i.e. inclusive call packages and pay TV offers including terms of access to specific content such as premium movies and sport.

2.12 In relation to these issues, and as set out further in this response, different competitors have adopted different market strategies and are seeking to use their relative strengths in competing in certain segments of the market.

2.13 The key point BT makes by way of introduction is that conditions relevant to any assessment of margin squeeze relating to BT's SMP in the WLA market and competition in the retail provision of SFBB services are radically different to the conditions relevant to the conceptual 'plain vanilla' case. As such, any finding of profit sacrifice under an imputation test may be <u>necessary</u>, but is, in and of itself, <u>insufficient</u> to imply an automatic finding of downstream distortion.

2.14 This issue is absolutely central in assessing both (i) the overall need for an additional SMP remedy over and above competition law and the other SMP remedies already in place, and (ii) the specific form of any additional remedy and the way it would be applied and enforced. Ofcom's failure to have adequate regard to these requirements represents a flaw that runs through the Consultation and Ofcom's proposals.

Existing legal/regulatory constraints on BT's pricing of VULA

2.15 To set a baseline against which to consider the need for further regulation of the type now proposed, it is important to establish up front the existing constraints BT faces around the terms on which it supplies VULA services. Any proper assessment of the risks of competitive problems arising should have regard to the fact that BT already faces two existing legal and regulatory constraints on its pricing behaviour.

(a) BT is subject to ex ante SMP remedies already imposed by Ofcom in relation to the provision of VULA services from the WLA market – i.e. as set out above, BT must provide VULA on FRAND terms, conditions and charges, and on an EoI basis (which ensures that BT's competitors can achieve technical replicability of any BT VULA based dual play broadband offerings).[4] In its 2010 FAMR Statement, Ofcom indicated that it would assess whether VULA was provided on fair and reasonable terms by

[4] BT notes that the SMP conditions imposed by Ofcom in the 2014 FAMR Statement (see Annex 29) include: the obligation to provide VULA on "*fair and reasonable terms, conditions and charges*" (Condition 1); the obligation that BT must "*not unduly discriminate [..] in relation to the provision of network access*" (Condition 4); and the obligation that BT "*must provide network access […] on an Equivalence of Inputs basis*" (Condition 5). For present purposes and throughout this Response, the term "FRAND" is used to refer to the obligation imposed by Conditions 1 and 4.

considering whether the VULA price supported effective downstream competition in the provision of SFBB services or whether any price/margin squeeze economic replicability concerns arose.

(b) Furthermore, BT must at all times comply with competition law. As referenced above, this means BT, as a vertically integrated supplier, cannot leverage dominance from upstream markets to foreclose competition downstream by removing the margin available to competitors. Clearly Ofcom's provisional No Grounds for Action ("**NGFA**") decision in relation to TTG's complaint under the Competition Act 1998 ("**CA98**")[5] is relevant in setting out the way in which competition law serves to prevent abusive, exclusionary margin squeeze activity. It also makes clear that no exclusionary competition concerns have been identified as of now in relation to BT's provision of SFBB.

2.16 Moreover, BT notes that in 2010 and 2014 Ofcom expressly decided against establishing additional SMP remedies that focussed on the absolute level of the VULA charge – e.g. by reference to the costs of provision – given constraints in the market from Virgin and copper SBB services, and given risks and uncertainties around unit costs of provision in light of the long term paybacks of upfront capital investments.[6]

2.17 These existing legal and regulatory constraints on BT's provision of VULA provide the appropriate counterfactual against which to assess Ofcom's proposals in the Consultation. Given that the central issue in this Consultation is whether the proposed remedy would (i) be a necessary additional measure and (ii) only if that is the case, a proportionate measure, it follows that Ofcom needs to show that the current set of constraints (in their current form, or if considered necessary, supported by guidance on their application) are themselves insufficient to address identified concerns with BT's potential behaviour before proceeding to consider any incremental regulation.

Structure of BT's Response

2.18 Having made these introductory observations, and in support of our overall view that Ofcom should fundamentally reconsider its approach to VULA margin regulation, in the following sections of this response, we set out:

(a) Our legal assessment of the Consultation, which is supported by a detailed annex (see **Section 3** and **Annex B**). Our analysis demonstrates that Ofcom has not met the legal test for imposing its proposed ex ante MST regulating the margins that BT must maintain in relation to SFBB based on VULA services.

[5] See Ofcom, *Complaint from TalkTalk Telecom Group plc against BT Group plc about alleged margin squeeze in superfast broadband pricing*, CW/01103/03/13, update note of 19 June 2014.

[6] See, for example para 1.34 of the 2014 FAMR Statement: "*We will not regulate the level of VULA prices during the next market review period, allowing BT to retain pricing flexibility on NGA pricing. In particular, we consider that competitive constraints will reduce the risk of unregulated VULA pricing levels (such as the pricing of current generation access ('CGA') services and Virgin's services). Further, there remains uncertainty about future demand for NGA services and the time profile over which NGA investment should be recovered. As such, determining the level of charges remains difficult and carries a risk of setting inappropriate price levels that would harm incentives for efficient investment (either expanding the network or improving technology) and BT's ability to experiment with pricing to encourage fibre take-up*".

In the context of Ofcom failing adequately to identify a problem that requires additional regulatory intervention:

(i) Ofcom has not reached the jurisdictional threshold for imposing its proposed condition under section 87(9) and section 88 CA03; and

(ii) Ofcom's exercise of its jurisdiction in proposing an ex ante MST condition would not be a proportionate way to address its objectives.

(b) A detailed assessment of the market in which SFBB services are currently supplied and will be supplied during this market review period to 2017 (see **Section 4**). This analysis is not designed to be exhaustive, but serves to demonstrate the inadequacy of the analysis conducted by Ofcom in the Consultation. In particular, this puts Ofcom's observations about BT's high retail share of VULA connections into the appropriate context of the strategies different competitors are adopting in the broadband market and emphasises the relative strengths of Sky, Virgin and TTG, in the provision of triple-play bundles;

(c) A detailed consideration of Ofcom's stated rationale and supporting evidence in identifying:

(i) Its specific regulatory objective in assessing the potential need for an additional VULA margin remedy (see **Section 5**);

(ii) The need for such an additional remedy over and above the existing constraints on BT's behaviour (see **Section 6**).

2.19 **Section 7** addresses Ofcom's proposal to include triple-play bundles and BT's provision of the BT Sport channels to SFBB customers in the test, and the requirement on BT to earn monthly margin to fully recover current average net costs of these services during start-up phase. This Section concludes that the MST proposed is an inadequate tool to assess the potential issues raised by BT TV and BT Sport.

2.20 Without prejudice to BT's primary submission as to the need for a test, we then address, in the context principally of a dual play assessment, the conceptual design of the proposed imputation test and the specific proposals for populating the proposed test for cost and revenue data (**Section 8**).

2.21 **Section 9** sets out our conclusions.

3. Ofcom's proposals are inconsistent with the applicable legal framework

Introduction

3.1 In Section 7 of the Consultation Ofcom sets out the basis on which it considers that the new, additional SMP remedy it is proposing to introduce is appropriate and satisfies the legal tests set out in the CA03 for the imposition of an SMP price control condition. It also seeks to demonstrate that it has had the utmost account of Recommendations issued under Article 19(1) of the Framework Directive, including the NGA Recommendation[7], the Costing and Non-discrimination Recommendation[8] and the BEREC Common Position on best practice in remedies in the WLA market[9].

3.2 BT attaches at Annex B to this response a detailed response to Section 7 which evidences that BT fundamentally disagrees with Ofcom's conclusions. It sets out why BT considers that (i) Ofcom has not reached the jurisdictional threshold for imposing its proposed condition under section 87(9) and section 88 of the CA03; and (ii) even if Ofcom had reached the jurisdictional threshold, Ofcom's exercise of its jurisdiction in proposing an ex ante MST condition would not be a proportionate way to address its objectives.

3.3 BT also considers that, on proper analysis, the Recommendations and BEREC Common Position support the position that if, some form of ex ante MST can ultimately be shown to be justified, in order to be apt and proportionate, it should:

(a) measure relevant downstream costs on an EEO standard without any adjustments;

(b) evaluate profitability on the basis of a dynamic, not static, analysis;

(c) allow for an assessment of the effects on competition on downstream markets, if there is a failure 'on the numbers' where that numerical failure is as a result of the inclusion of bundled offerings – i.e. the MST should not be a 'bright line' test of compliance

Summary of BT's submissions on jurisdictional issues

3.4. In summary, Ofcom has not met the statutory requirements of section 88(1)(a) and 88(3) for imposing a section 87(9) condition.

(a) Ofcom has not undertaken sufficient market analysis as required under section 88(1)(a) as to whether there is a risk that adverse effects would arise from price distortion. In this respect, Ofcom has not correctly identified the primary counterfactual scenario against which to analyse whether there is a risk of adverse effects, which is that the existing status quo of ex ante regulation through the FRAND and EoI SMP conditions, supported by ex post

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[7] *Commission Recommendation on regulated access to Next Generation Access Networks (NGA)*, 20 September 2010 (2010/572/EU).

[8] *Commission Recommendation on consistent non-discrimination obligations and costing methodologies to promote competition and enhance the broadband investment environment*, 11 September 2013 (2013/466/EU).

[9] *BEREC common position on best practice in remedies on the market for wholesale (physical) network infrastructure access (including shared or fully unbundled access) at a fixed location imposed as a consequence of a position of significant market power in the relevant market*, 8 December 2012 (BoR (12) 127).

competition law, would persist. As a result, it has not met the requirements for imposing an MST at all.

(b) Ofcom has not properly shown that BT would have the ability and incentive to impose a price squeeze. Nor has Ofcom set out what has changed since its previous consultations that would lead it to a different conclusion as to the need to impose additional regulation.

(c) Ofcom has not considered the position of actual and potential SFBB customers in order to evaluate whether there is a material risk that they would suffer adverse consequences.

3.5 Given the complexity of the broadband market, the uncertainty of developments in SFBB and the differentiation of products offered by competing CPs, Ofcom must carry out a careful market analysis as to the likely effects on consumers if it is to justify imposing an additional regulatory condition. Instead, Ofcom bases its conclusion on a speculative and unevidenced concern as to possible future developments, and thus fails to meet its own anti-interventionist and evidence-based standard.

3.6. Indeed, had Ofcom carried out this analysis, BT believes that it would have reached the conclusion that no additional regulatory condition of MST is justified. In this respect, BT notes that:

(a) to the extent that Ofcom has concerns that adverse consumer effects might arise at some point ***after 2017***, there will be a further opportunity in the next market review to consider whether it is then necessary to introduce regulation;

(b) in addition, to the extent that there were any material changes giving rise to such concerns ***prior to 2017***, which Ofcom itself currently considers to be unlikely, Ofcom could not only exercise its substantial regulatory powers under the existing regime (i.e. the FRAND condition, EoI and/or competition law), but also Ofcom could potentially carry out an additional review in order to impose remedies within that period under Section 86 CA03.

3.7 These issues are expanded upon at the appropriate points within the remaining sections of this response and in Annex B.

Summary of BT's submissions on proportionality

3.8 The proposed MST condition would infringe the principles of proportionality binding on Ofcom because:

(a) Ofcom has not undertaken an adequate Impact Assessment – it has not sufficiently considered regulatory alternatives that might also meet its objectives or conducted a sufficient cost benefit analysis of each of those alternatives.

(b) It has not sufficiently considered BT's investments in SFBB and related markets (in particular sports content and Pay TV), both in terms of earning an appropriate return on investment and on future investment incentives, for the purposes of section 88(2) CA03.

(c) The proposed MST condition is neither necessary to achieve Ofcom's objectives nor the least onerous option. In particular, the adjustments that are included in the test would result in a greater level of margin for competitors than is needed for them to compete effectively with BT. This would provide competitors with a windfall, in what is a highly competitive market in which they are already successfully operating and would cause distortions in the markets affected by the test.

(d) As such, the proposed condition risks having significant negative effects on competition both on the broadband market itself and on competition in other related markets.

3.9 Overall, these factors are not weighed adequately in Ofcom's Consultation and they render the proposed VULA SMP condition disproportionate.

3.10 These issues are expanded upon at the appropriate points within the remaining sections of this response and in Annex B.

Summary of BT's submissions in relation to the Recommendations and UK law

3.11 Ofcom has not properly taken account of all Recommendations issued under Article 19(1) of the Framework Directive. The Costing and Non-discrimination Recommendation clearly recommends that NRAs should measure relevant downstream costs on an EEO basis unless (i) market entry or expansion has been frustrated in the past or (ii) where very low volumes of lines and their significantly limited geographical reach as compared to the SMP operator's network indicate that objective do not favour the acquisition of scale by alternative operators. Ofcom has not shown that either is the case.

3.12 Furthermore, any adjustments made to the EEO test "*should not go beyond that of a market structure with a sufficient number of qualifying operators to ensure effective competition*". The adjustments to the EEO that Ofcom propose go far beyond what is contemplated by the Recommendation given that there is already a sufficient number of effective competitors.

3.13 While Ofcom states that it has taken utmost account of the Recommendations, it has also not following the approach recommended in Annex II of the Costing and Non-discrimination Recommendation as to how to measure costs, which leads to Ofcom proposing a disproportionate measure.

3.14 Both the Costing and Non-discrimination Recommendation[10] and the BEREC Common Position recognise that there may be circumstances where a failure to pass an ex ante replicability test 'on the numbers' may not be harmful to competition. The problem with an 'on the numbers' only ex ante test involving bundled offerings is in particular recognised in an ERG report referred to in the BEREC Common Position.[11]

[10] Article 56(c): "*Where the NRA considers that a retail offer which is not economically replicable <u>would significantly harm</u> competition, it should make use of its [enforcement] powers . . .to request the SMP operator to cease or delay the provision of the relevant retail offer pending compliance with the requirement for economic replicability*."

[11] BP49b which refers to the "*Report on the Discussion on the application of margin squeeze tests to bundles, ERG (09) 07, March.*" See in particular paragraphs 111 to 114.

3.15 This supports BT's position that it is not appropriate or proportionate to impose an ex ante test including bundles which is incapable of involving any assessment of whether the retail prices BT is charging are having or can reasonably be expected to have a distortive effect on the market.

3.16 Finally, BT considers that Ofcom risks an unlawful exercise of its discretion by introducing a test which includes BT TV and BT Sport, which involves substantial modification of the EEO standard, and which involves application of a strict numbers based bright line test, in that this would, in practice, make it impossible in practice for the statutory requirements of section 96A(5) to (7) CA03 to be complied with. It is a fundamental principle of administrative law that a public body must not exercise its discretion in a manner that frustrates the policy of an Act of Parliament.

4. The Market Context for this Consultation

Introduction and summary

4.1 In the previous Section, BT submitted that Ofcom has not passed the jurisdictional hurdles required to impose an MST. In particular, Ofcom has not carried out sufficient market analysis in order to justify its proposals. Given the range of CPs with different priorities and strategies in this market, any analysis by Ofcom should involve a detailed review of all of the evidence, both on current levels of competition and also on indicators of how the market will develop. There is a high level of responsibility on Ofcom to carry out this analysis properly and, in so doing, Ofcom should at least take into account the additional evidence set out in this Section before reaching any conclusion on the need for an ex ante MST.

4.2 This Section provides the relevant context for BT's assessment of each of Ofcom's key proposals as set out in the Consultation, in particular in identifying its overall regulatory aim and considering its options for achieving this (Section 5), in considering options for regulating the VULA margin (Section 6), and in its approach to designing the scope and detail of the proposed new SMP remedy (Sections 7 and 8).

4.3 Specifically, this Section addresses the following points:

(a) On a static analysis, the retail broadband market (both in relation to fibre and copper) is highly competitive and the evidence suggests that, even on a dynamic analysis, it is highly likely that this will remain the case given current commercial, regulatory and legal constraints;

(b) Current fibre volumes and forecasts for the market review period reflect the commercial choices CPs have taken about competing in the overall broadband market, rather than any actual or potential competition 'problem' arising as a result of BT's (actual or potential) distortive pricing strategies;

(c) Rather than diminishing, competition for fibre broadband is set to increase rapidly over the current market review period, such that current subscriber shares are not instructive as to future shares; and

(d) Competition for the provision of broadband services in triple-play bundles is largely shaped by Sky's dominance in content markets and the wholesale terms on which it makes key channels available to its competitors.

The retail broadband market (both in relation to fibre and copper) is highly competitive

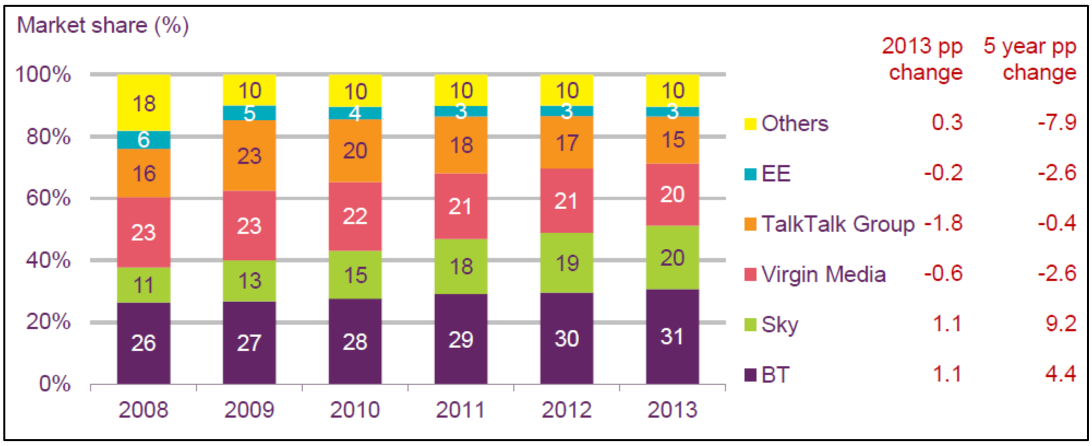
4.4 In its 2014 Wholesale Broadband Access ("**WBA**") Statement[12], Ofcom concluded that there remained a "*single retail product market covering all [broadband] speeds*" (paragraph 3.30). Ofcom noted that it "*saw no clear break at present in the 'chain of substitution' between different service speeds*" and that "*there was not sufficient evidence for a separate market emerging during the next market review period*".

[12] Ofcom, *Review of the wholesale broadband access markets*, 26 June 2014.

4.5 This was supported by reference to a number of sources of evidence; for example "*CPs' internal documents suggest that mass market demand for SFBB services has yet to emerge*", leading Ofcom to conclude that "*the need for SFBB … will [not] be sufficiently widespread to define a separate market*".[13] Looking forward, Ofcom considered that "*prices for SFBB are likely to remain low in order to make it attractive for the large number of consumers still on CGA to migrate to SFBB*"; Ofcom also noted that charging a premium for SFBB "*is consistent with a chain of substitution, even though historically some providers have not done so*".[14]

4.6 Clearly, therefore, based on Ofcom's own analysis CPs with copper broadband offerings are able to compete with SFBB propositions and Ofcom does not expect this to change within the market review period.

4.7 In this respect, Ofcom has consistently found that the retail broadband market in the UK is highly competitive, with no one provider having a substantially larger market share than its competitors.[15]



4.8 In terms of international comparators, the average per-capita broadband revenue generated by providers in the UK is amongst the lowest in developed nations with the lowest 5 year CAGR.[16] As Ofcom notes in its 2013 Communications Market Report, "*the UK has low fixed broadband prices*". This is an important measure of competition in the UK broadband market. There is no competition problem in the UK broadband market, and no evidence has been put forward that there is.

Current fibre volumes reflect strategic choices taken by CPs to date, rather than any actual or potential competition problem

<u>Overview</u>

4.9 In Section 3 of the Consultation, Ofcom places great weight on BT's current share of VULA connections. However it also recognises that "*current uptake is not necessarily indicative of significant competition concerns or the long term outcome*" (paragraph 3.62).

[13] Paragraphs 3.46 and 3.43.
[14] Paragraph 3.51.
[15] Ofcom Communications Market Report 2014, Figure 5.39.
[16] Ofcom Communications Market Report 2013, Figure 6.49.

4.10 Current fibre volumes are a result of the respective rational strategic choices of CPs to date. In this regard, it is notable that:

(a) BT’s strategy has been actively to upgrade its base to fibre, which has been equally available to all CPs since day 1 given the availability of VULA on EoI terms;

(b) In line with its own strategic incentives, Openreach has attempted to drive fibre take up by all its CP customers, in particular BT Consumer, Sky and TTG;

(c) Virgin’s broadband strategy – of which Ofcom fails to take proper account – has also been to upgrade its customer base to SFBB; and

(d) In contrast to BT and Virgin, TTG and Sky started promoting SFBB slowly, choosing instead to maintain a significant focus on copper broadband, in accordance with their own commercial priorities, even though they have had full EoI access to GEA on FRAND terms since it was launched, the same as BT’s own retail operations.

BT’s retail broadband strategy has been to maximise the returns on its fibre investment by actively encouraging existing broadband customers to upgrade to SFBB

4.11 Since its launch in 2010, the focus of BT’s retail fibre strategy has consistently been weighted towards upgrading its existing copper broadband base rather than acquiring customers from other providers. This pro-competitive initiative reflected BT’s broader strategy of providing its customers with the highest quality broadband experience while making its multi-billion pound investment in the fibre network a commercial success.

4.12 The essential performance requirement to justify the investment in fibre networks upstream has always been the necessity to get large volumes of customers – both from BT’s retail divisions and other CPs – on to the fixed cost infrastructure. BT therefore decided that its retail operations should prioritise the sale of retail fibre broadband in order to make its enormous investment commercially viable. By contrast, other CPs are free from the responsibility of making BT’s fibre investment pay-off and have made different strategic choices accordingly. BT’s focus on regrading its customers from copper broadband to fibre broadband is evidence of this strategy. In contrast, the relatively slow take up by other CPs has been a source of risk to the BT Group business case.

4.13 As Ofcom notes in footnote 79 of the Consultation, [ ]% of BT’s net adds were regrades from its copper base. While this figure has since reduced slightly, it remains the case that the majority of BT’s fibre net adds (over [ ]% in 2013/14) were regrades from its base of copper broadband subscribers, even though BT’s copper base itself comprises less than 30% of the available copper base. As set out in the chart below, this trend has continued for the first four months of 2014/15 for which data is available.

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4.14 BT notes that this upgrade strategy has been open to all CPs on EoI terms since the launch of GEA in 2010, and even before Ofcom required BT to offer VULA. As noted by Ofcom in its 2010 WLA Statement, the requirement to provide VULA to all CPs on fair, equivalent and non-discriminatory terms was imposed to "*allow competitors to deliver services over BT's new NGA network, with a degree of control that is similar to that achieved when taking over the physical line to the customer*" (paragraph 1.5). Indeed, in January 2013 Sky's CEO, Jeremy Darroch, noted as follows: "*if fibre starts, so we start to see more demand from customers for fibre, then we're going to be well placed to push into that*".[17] In contrast, as far back as 2012 he had noted that fibre appeared to be "*central*" to BT's and Virgin's strategies.[18]

4.15 The fact that Sky and TTG were slow to promote SFBB in the early, high-risk years was simply a matter of their strategic choice. As a result, it is wrong merely to seek to extrapolate from existing VULA subscription rates when the drivers for differing shares of SFBB subscriptions are now changing as commercial priorities develop.

Openreach has strong incentives to promote increased fibre demand by CPs and has engaged in significant pro-active investment in new products and technologies

4.16 Reflecting (i) the goal of maximising BT Group's returns on its substantial fibre investment and (ii) the fact that it is incentivised to serve successfully all of its customers equally, Openreach has consistently pro-actively engaged with its CP customers to promote and enable SFBB. Ofcom has failed to examine or take into account the evidence that demonstrates Openreach's substantial efforts to sell its GEA products to non-BT CPs.[19] This makes clear that the reluctance on the part of other CPs was simply a matter of their own strategic choices, based on their views as to what customers demanded. This demonstrates that, rather than any inherent

[17] Interim 2012/2013 British Sky Broadcasting Group plc Earnings Presentation (UK), 31 January 2013.
[18] British Sky Broadcasting Group plc at Goldman Sachs Communacopia Conference, 19 September 2012.
[19] See, for example, BT's response to Question 2.6 of the 1st s135.

advantages enjoyed by BT Consumer, other CPs are perfectly capable of competing with fibre broadband products if they choose to.

4.17 Openreach has strong incentives to grow new incremental volumes of fibre customers. The long term economics of the BT Group investment case are highly sensitive to volumes, which means that take-up is required across a range of CPs and not just downstream BT. Hence Openreach's extensive and proactive engagement with CPs. Currently Openreach's GEA fibre product is purchased directly by 19 CPs serving consumers and 44 CPs focussed on businesses.[20] Over 70 further CPs offer SFBB services based on BT Wholesale connectivity. This is a further indication of the increasing competitiveness, and complexity, of the UK retail broadband market in which a number of competitors are developing existing and new business models. Consideration of these developments is not reflected in the Consultation. As a result, and as set out in paragraphs 4.59-4.64 below, the share of fibre net adds among other CPs has been steadily growing.

4.18 Ofcom's approach to regulating fibre since 2010, largely reaffirmed in 2014, is appropriate for promoting competition in SFBB. It allows CPs and end-users to benefit from the 'shared' economies of scale and scope inherent in the design of the Openreach NGA infrastructure, the flexibility in product specifications, pricing, propositions and contractual terms, and supports migration to new technologies and between providers. It has supported major investment by BT and others (such as Virgin) in the UK's NGA infrastructure and the increasing demand for SFBB services from consumers.

<u>Virgin's broadband strategy has also been to upgrade its customer base to SFBB (and latterly to expand its network)</u>

4.19 Virgin's network – itself also the result of a multi-billion pound investment – is capable of delivering high speed broadband to about half of all households in the UK. It has by far the largest number of high speed broadband subscribers in the UK, standing at over 4.4m at the end of Q1 2014/15 – over twice as many high speed broadband subscribers as BT. Even <u>if</u> Ofcom's concern set out at paragraph 3.47 of the Consultation were correct and there is a risk that BT could build up a significant share of SFBB by the end of the next market review period (which BT does not accept), Virgin would continue to operate as a strong constraint on BT, that Ofcom has failed properly to take into account.

4.20 In August 2014, Virgin announced the largest expansions of its network since the company was formed in 2007. It plans to make its network available to 100,000 further homes in East London. In its press release, Virgin notes that its customers will benefit from broadband speeds of up to 152Mb, "*far ahead of BT or any other major provider*".[21] Virgin has also invested heavily to increase broadband speeds across its entire network.[22] This shows that Virgin is continuing to invest and actively compete for customers. In order to remain competitive, BT will also need to continue to invest and Ofcom is wrong to consider that its investment is now substantially complete.

[20] http://www.superfast-openreach.co.uk/at-home/buy-it-now.aspx
[21] http://about.virginmedia.com/press-release/9444/virgin-media-takes-superfast-broadband-to-east-london
[22] http://about.virginmedia.com/press-release/9418/virgin-media-launches-broadband-twice-as-fast-as-the-rest

4.21 The significance of Virgin's investment in terms of increasing infrastructure – and, in due course, retail – competition is addressed at paragraph 4.57 below.

<u>TTG and Sky have to date prioritised copper over fibre broadband</u>

4.22 The decision of other CPs, such as TTG and Sky, to promote copper over fibre broadband is commercially rational. Rather than commit investments in what was a relatively new technology, they decided instead to <u>'sweat' their existing assets</u>.

(a) In this respect, it is important to recall that Sky and TTG have in recent years committed significant investments to unbundling exchanges. Ofcom's 2014 WBA Statement shows that the number of BT-only exchanges declined dramatically in recent years, i.e. from 3,389 in 2010 to 2,508 in September 2013.[23] In terms of coverage of households, Ofcom also notes that 95.5% of UK delivery points have now been unbundled by at least one CP (paragraph A6.34). Both Sky and TTG have UK network coverage exceeding 90%, suggesting that exchange unbundling has more or less reached saturation point.

(b) It is clear therefore that although a large number of exchanges have only relatively recently been unbundled, further extensive unbundling is unlikely. This means in practice that – all other factors remaining equal – some CPs may adopt a more favourable balance towards copper broadband than others for a few years to come in order to utilise upfront investments in LLU infrastructure. This in and of itself cannot be indicative of an underlying competition problem, but rather the result of commercial choices.

4.23 Moreover, given the primary focus of other CPs on 'value' broadband propositions, it is clear that copper broadband is at present largely <u>sufficient to address customer demand</u>.

(a) For example, TTG has consistently stated that "*demand for fibre from our customers remains modest except when it can deliver transformational improvements in their broadband experience, such as for those customers who currently achieve less than 2Mbps speeds and might wish to take TV*."[24] This is consistent with Ofcom's research showing that for most subscribers and most activities, copper broadband and SFBB are both equally suitable.

(b) Similarly, Sky has stated that even with customers who contacted it about fibre following marketing drives, it "*found very much that customers prefer the DSL offer and the value proposition we have there*"[25]. This interpretation of customer demand for fibre and the perceived value customers will attach to fibre speeds will inevitably underpin strategic choices: they do not evidence a competition problem that needs to be addressed.

(c) Moreover, and of crucial importance for Ofcom's forward-looking assessment for the current market review period, TTG also notes that: "*We expect that*

[23] WBA Statement, paragraphs A6.43ff.
[24] TalkTalk Telecom Group PLC, Interim Management Statement for the 3 months to 30 June 2014 (Q1 FY15), 23 July 2014.
[25] Interim 2013/2014 British Sky Broadcasting Group plc Earnings Presentation (UK), 30 January 2014.

demand will grow steadily with heightened awareness of the product and growing bandwidth usage."[26] In these circumstances, one would expect that TTG would begin to sell more fibre broadband over time and that is exactly what is now happening. Given the relatively recent shift in commercial focus, it is very difficult to predict how competition will develop between the various SFBB providers. Ofcom has made some sweeping assumptions about future rates of take-up, but has not fully assessed all of the current market evidence in this regard.

4.24 Another key reason for the starkly different strategies adopted by BT on the one hand and Sky and TTG on the other is the nature of the fibre network roll out.

(a) In particular, it was only in early 2014 that Openreach had rolled out fibre to two-thirds of UK premises, thereby offering what could, to all intents and purposes, be described as a 'national' network. Before reaching this landmark, however, Sky and TTG would have been reluctant to commit too much advertising spend to a national fibre-specific campaign when SFBB was only in fact available to a minority of customers. National marketing campaigns targeted at copper broadband subscribers would have provided far better value for money.

(b) For example, in May 2013 Jeremy Darroch noted that any "*pockets*" of fibre demand would be met through 'below the line' advertising "*because it's [i.e. fibre] is not yet national*"[27]. Sky's first 'above the line' advertising campaign was launched in June 2013. Similarly, TTG only offered SFBB to new customers for the first time in Q2 2013/14. The rapidly increasing availability of SFBB throughout the UK in recent months has dramatically changed the incentives of Sky and TTG to launch national advertising campaigns in order to drive uptake.

4.25 The key developments noted above are not reflected in the Consultation. Indeed, Ofcom appears not to have examined the strategies of BT's competitors closely, merely noting that different CPs "*may have sought to upgrade existing customers/promote fibre at different rates, depending on their own strategic focus and commercial strategy*" (paragraph 3.62). BT considers that is incumbent on Ofcom to assess in detail the available evidence, rather than relying on assumptions. A proper analysis clearly shows that while CPs could and still can promote fibre in a similar fashion to BT, they have chosen not to do so.

Fibre competition is ripe to increase rapidly over the current market review period

Overview

4.26 The previous sub-section noted that, aside from BT and Virgin, the promotion of SFBB to date has been far less significant than for SBB. Recent trends and developments, however, demonstrate that this position has already started to change,

[26] TalkTalk Telecom Group PLC, Interim Management Statement for the 3 months to 30 June 2014 (Q1 FY15), 23 July 2014.
[27] Q3 2012/2013 British Sky Broadcasting Group plc Earnings Conference Call (UK), 2 May 2013.

and that the promotion of SFBB is likely to continue to increase during the market review period.

4.27 Virgin began offering high speed broadband service in 2008 ahead of BT. BT Consumer (formerly BT Retail) launched its consumer fibre broadband proposition in 2010. However, other CPs began actively promoting fibre much later, with Sky launching its first ‘above the line’ advertising campaign in June 2013. TTG only offered SFBB to new customers for the first time in Q2 2013/14.

4.28 Nevertheless, it is notable that in recent months the provision of fibre broadband has become increasingly competitive, with Sky and TTG putting a much greater focus on fibre, while Everything Everywhere (“**EE**”) and other providers are also increasingly promoting their offerings. In addition, up to 140 other providers also offer fibre over the Openreach network and, in a relatively short space of time, have attained a combined base of over 500,000 customers, a point which Ofcom appears to ignore.

4.29 The remainder of this Section demonstrates that the market in which BT Consumer operates, in particular in relation to fibre propositions, is characterised by low barriers to entry, already competitive and set to become increasingly so over the current market review period:

(a) Openreach has taken active steps to drive fibre adoption among all CPs;

(b) As a result, CPs are increasingly offering compelling, profitable fibre offerings;

(c) This is also because, regardless of any changes in commercial strategy, other CPs are now at a cost advantage regarding fibre vis-à-vis BT due to technological developments and recent Ofcom regulation;

(d) In addition to these developments downstream, growing infrastructure investments upstream will also lead to greater retail competition.

4.30 This Section will also demonstrate that:

(a) Due to the increasing competition, BT’s share of net adds is already falling and this trend is likely to continue; and hence

(b) Current SFBB subscription rates (and BT forecasts made at a point in time) are therefore not representative of potential future rates/shares.

<u>Openreach has taken active steps to drive fibre adoption among all CPs</u>

4.31 Since the introduction of GEA in 2010, Openreach has actively engaged with all CPs to overcome any technical and/or commercial problems associated with the provision of SFBB.

(a) For example, CPs were keen to wait for the availability of self-install options before pushing SFBB. CPs were mindful that installations carried out in the home by an engineer usually required a customer to take time off work in order to wait for an appointment, thereby adding to the perceived and actual inconvenience of upgrading to SFBB. Dido Harding, TTG’s CEO, previously noted that "*we think what will make it more attractive for customers to want to buy is that the product itself gets simpler and easier to install*".[28] As set out in greater detail below, self-install is now readily available; so to the extent that this reduced other CPs' willing to sell fibre, this obstacle has also been overcome.

(b) In addition, TTG has also noted that the complications previously associated with installation led to delays in pushing SFBB. For example, in July 2013 Dido Harding stated as follows: "*At the moment, if you are a new customer joining TalkTalk, you can't actually simultaneously order MPF and fibre in an automated way. It makes that joining process very complicated*."[29] Again, as set out below, this issue has been resolved.

4.32 It is clear, therefore, that Openreach has a positive track record in innovating and working with its customers to develop the product set to meet its VULA requirement, both in terms of performance and functionality over recent years. The flexibility permitted by the existing regulatory framework has supported this cooperative approach with major product changes having already been launched in recent years (covered further below) and additional major technology and product developments being planned. In addition, the growth in fibre take-up by CPs across the board (as discussed in paragraphs 4.35-4.43) plus new technological developments is expected to drive significant new incremental capital investment running into hundreds of millions over the next few years. Initial estimates put the new investment required at [ ] given likely demands for higher performance and greater capacity in the NGA network. All this points to a need for ongoing capital investment for some years to come and Ofcom's regulatory policy needs to recognise the scale of BT Group's investment, the long term nature of the business case and the financial and operational risks faced by BT in its implementation.[30] CONFIDENTIAL

4.33 In this respect, Openreach is committed to continuing to work with its customers on future requirements and on a transparent development process and publication of regularly updated product roadmaps. For example the track record on development since the 2010 WLA market review is substantial and this includes the two most significant additions to the portfolio proposed in that review ('wires-only' and FVA – see below).

4.34 Examples of recent developments by Openreach include:

(a) *Wires-only*[31] (also known as self-install), which was trialled extensively and launched to plan in 2013. As set out in paragraphs 4.51, it has now become a major contributor to the growth in CP take-up.

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[28] TalkTalk Telecom Group PLC Preliminary 2012 Earnings Conference Call, 17 May 2012.
[29] TalkTalk Telecom Group PLC Q1 2013 Interim Management Statement Conference Call, 24 July 2013.
[30] See the Plum Consulting report provided with BT's FAMR response for further details.
[31] 'Wires-only' is a generic term used to cover several major underlying developments to the GEA product including 'Self-Install', 'Primary Connection Point (PCP) only' installation and Customer Premises Equipment (CPE) enablement.

(b) *Fibre Voice Access (FVA)* is a voice connectivity solution which is seen as an essential element of the regulatory framework to enable voice competition over Fibre to the Premises ("**FTTP**"). FVA was launched in Spring 2012.

(c) *Other product developments*: Other significant examples of collaborative developments over recent years have included:

(i) Multicasting – the ability to convey multiple and duplicated traffic streams through the GEA access network in an economic and efficient way;

(ii) Simultaneous Provision ("**SIM2**") – a development providing the ability for a CP to order a SIM2 product bundle for GEA- Fibre to the Cabinet ("**FTTC**") and WLR or MPF, so that orders are provided locked together for the delivery of the two services, ensuring both are delivered on the same day;

(iii) FTTP on Demand ("**FoD**"), a new service enabling FTTP based GEA services to be ordered in FTTC areas;

(iv) An extensive range of new FTTP products with wide-ranging speed capabilities, including a 330/30Mbps product, have been developed and are available in FTTP footprint areas such as new fibre sites.

<u>Sky, TTG and other CPs are increasingly offering compelling SFBB offerings</u>

4.35 After a relatively slow start (due to differing strategic priorities and incentives, as set out above) and a period of modest advertising, principally 'below the line' to existing customers, Sky, TTG and other CPs are increasingly advertising highly attractive offers above the line. The attractiveness of these offers is reflected in their recent net adds figures.

4.36 In line with the developments described above, **Sky** has recently promoted a number of high profile and attractive 'above the line' campaigns (see Annex E for further detail), for example:

(a) From 15 July 2014, Sky advertised a price for their fibre product of £5 for the first 6 months and £20 per month thereafter.

(b) Sky Sports customers are able to get two years free Sky Broadband Unlimited when they activate Sky Sports 5, which is available at no extra cost as part of the standard price of the Sky Sports pack. The fibre offer as part of this promotion – which has been given a prominent role - is 12 months half price Sky Fibre Unlimited at £10 per month followed by 6 months at the standard price of £20 per month.

(c) Even before introducing such high profile advertising, BT estimates that Sky's fibre base stood at nearly 250,000 at the end of 2013/14 and reached nearly 300,000 at the end of Q1 2014/15. [ ] CONFIDENTIAL

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4.37 The stark impact which advertising and ATL offers can have on SFBB volumes can be demonstrated even by the relatively limited campaigns launched by Sky to date. For example:

(a) [ ]

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(b) [ ]

(c) [ ]

4.38 The clear impact of these developments on the orders placed by Sky with Openreach is set out in the chart below.[32] The chart also shows the impact of self-install (or "PCP-Only" orders) on Sky's order profile.

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[32] The graph illustrates the profile using orders received on a weekly basis rather than orders completed.

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4.39 **TTG** has also increasingly promoted SFBB offers:

(a) From 30 June 2014, TTG started selling their TTG Superpowered fibre services half price (£6.75) for the first 6 months. TTG also offers a fibre package to its existing customers for just £5 extra per month.

(b) The chart below taken from TTG's website in August 2014 details the savings TTG claims to offer over other providers' fibre propositions.

	TalkTalk	sky	Virgin media	BT	plusnet	EE
Product	TalkTalk SimplyBroadband with Fibre Medium	Broadband Unlimited Fibre & Talk Weekends (Without TV)	Big Connection (50 MB)	Unlimited BT Infinity 1	Unlimited Fibre and Calls	Fibre and Weekend Calls
Monthly fee	£13.50	£20.00	£15.50	£23.00	£14.99	£19.95
Line rental	£15.95	£15.40	£15.99	£15.99	£15.95	£15.75
Total monthly fee	£29.45	£35.40	£31.49	£38.99	£30.94	£35.70
Postage & set up fees	£5.00	£56.95	£0.00	£36.95	£5.99	£0.00
Usage	Totally Unlimited	Totally Unlimited	Unlimited	Totally Unlimited	Unlimited	Unlimited
Inclusive calls	N/A	Weekend	Weekend	Weekend	Evening & Weekend	Weekend
Contract	18 months	18 months	12 months	18 months	18 months	18 months
Total cost(over 18 months)	£535.10	£694.15	£566.82	£717.77	£562.91	£642.60
Total SAVINGS with TalkTalk over 18 months*	N/A	£159.05	£31.72	£182.67	£27.81	£107.50

*Total savings include connection and delivery fees

(c) TTG's fibre base stood at over 200,000 at the end of FY 2013/14 and grew by a further 34,000 in Q1 2014/15. Forecasts provided to Openreach indicate that [[redacted]]. CONFIDENTIAL

(d) TTG's rapid fibre take up to date and increased forecasts are demonstrated in the graph below. It is notable that the significant take up in Q2 coincided with TTG offering SFBB to new customers at the point of sale for the first time.

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4.40 [ ]

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4.41 **EE** has increasingly started pushing stand-alone fibre broadband service. Following its successful launch of high-speed, 4G mobile services in 2013, it is using its strong position in order to capture a potential upsell opportunity to its c.27 million mobile customers.

(a) EE offers unlimited Fibre and weekend calls from £5.00 per month for the first 3 months, £19.95 thereafter. In Q4 2013/14, EE renewed its fibre focus by promoting fibre and 4G mobile bundles, combined with increased promotion in its nationwide network of stores.

(b) In a recent report in the Daily Telegraph, it was noted that EE offers a contract buyout deal worth up to £100 in order to encourage switching. The article quotes a broadband expert at uSwitch.com as follows:

> "*EE's really going for the jugular with its £100 buy-out promise. This has been around for a while, but it's only now EE's really shouting about it. It means that people unhappy with their current service but locked into a contract will be able to wriggle out of it – with EE footing the bill. It's every broadband provider's worst nightmare – and it means they will have to work that bit harder to keep customers happy and loyal.*"

(c) BT estimates that EE has a fibre base of nearly 200,000, with strong net adds in the last two reported quarters of 19,000 and 30,000 respectively.

4.42 A growing number of other ISPs are now selling fibre broadband using the Openreach network. Larger ISPs in this segment include Zen Internet, Primus Saver and Eclipse. There are also new innovative SFBB providers such as Relish Broadband, which claims to provide similar speeds to fibre but over 4G networks. While the service is currently focussed in London, Relish says that it plans to increase coverage across the rest of the UK. The only major brand ISP which does not currently provide fibre is the Post Office, which has a base of over 100,000 copper broadband customers.

4.43 Should CPs – as seems increasingly likely – decide to place equivalent emphasis to BT in promoting fibre, it is clear that one should expect a very material change in overall net adds. Ofcom has not, however, conducted a full assessment, relying instead solely on BT's forecasts. See further Section 5 below.

<u>CPs are able to offer profitable fibre offerings</u>

4.44 Reflecting the increasing advertising of fibre propositions from CPs, it is clear that fibre propositions are also being supplied profitably to consumers.

4.45 **TTG** has previously stated that fibre customers are "*revenue and EBITDA accretive*" and that any incremental subscriber acquisition costs pay back within an 18 month contract terms.[33] According to Dido Harding, fibre is a "*profitable product for us to sell*"[34], and in a recent results call, Ms Harding noted the following:

> "*net/net, [SFBB] is extremely good incremental business for us that is return on capital enhancing because it costs us very little to enable exchanges to sell fibre*"[35]

4.46 For its part, **Sky** has previously stated that it has "*attractive broadband economics*", with its 40mb fibre product generating gross profit of £20 and gross profit margin of 53%, while its 80mb product generates gross profit of £26 and gross profit margin of 55%. This compares favourably with a gross profit margin of £14-18 on its copper Broadband Unlimited product. As early as January 2013, Jeremy Darroch noted that "*the increased contribution from a DSL customer taking fibre is anything from GBP2 up to GBP12 per customer per month*".[36] Sky's healthy profitability overall is reflected in its latest ARPU figures, which increased from £576 vs. £571 for the previous quarter and £569 for the same quarter last year.

4.47 While **EE and other providers** haves not to date reported profitability of fibre, they are clearly pushing fibre propositions actively, with "*impressive*" broadband net adds driven by attractive combined fixed/mobile promotions.[37] EE's latest results noted that fixed line revenues overall were up +19.6% year-on-year.

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[33] Interim 2012 TalkTalk Telecom Group PLC Earnings Conference Call, 13 November 2012.
[34] TalkTalk Telecom Group PLC Preliminary 2012 Earnings Conference Call, 17 May 2012.
[35] Preliminary 2013/14 TalkTalk Telecom Group PLC Earnings Conference Call, Thomson Reuters Transcript, 15 May 2014.
[36] Interim 2012/2013 British Sky Broadcasting Group plc Earnings Presentation (UK), 31 January 2013.
[37] '*EE UK Sees Home Broadband Surge to 775000 Users'*, ISP Review, 25 July 2014.

4.48 The profitability of SFBB means that in practice CPs are well poised to offer compelling discounts to customers, or other distinctive competitive features, as they see fit, while still being able to make a profit over the ACL. This evidence makes clear that there is no margin squeeze, and no margin problem inhibiting vibrant competition in the supply of SFBB products.

4.49 If anything, the only complaint (some) CPs appear to have in relation to their current pricing of SFBB is that the gross margin is lower on fibre than on copper. However even TTG has recognised that these lower (albeit still positive) margins are at least partially offset by lower costs to serve and lower churn.[38]

<u>Other CPs are now able to build a fibre base more cheaply than BT</u>

4.50 Due to recent technological innovations and Ofcom regulatory action, BT's competitors now face lower relative costs than BT, both when upgrading their existing bases to fibre and in migrating across any existing fibre broadband subscribers from competitors. Ofcom has not taken account of these cost advantages for competitors, but only those areas in which Ofcom considers that BT has a relative advantage. In addition, these developments will likely alter the incentives noted above, in particular as regards recoupment of LLU investments.

4.51 In particular, it now costs considerably less to upgrade a customer to fibre due to the increasing availability of self-install options. A managed installation service (which provides additional customer support) costs £99 without the Openreach modem and £117 with the Openreach modem. The vast majority of BT's SFBB installations to date have been carried out through the managed installation service. In contrast, self-installation is available at just £49. The savings have been reflected by CPs: for example, in May 2014 TTG launched a new Super Router, enabling fibre self-install and notes on its website that self-installation saves consumers £50.[39] [ ] leading to dramatic cost savings relative to those that BT has faced. CONFIDENTIAL

4.52 In addition, in its 2014 FAMR Statement Ofcom concluded that the costs of switching are important for retail competition (paragraph 1.35). It therefore decided to reduce the charge for VULA to VULA migrations from £50 to £11. In order to further facilitate switching and promote retail competition for VULA-based services, Ofcom also imposed a one month minimum term for VULA migrations at the wholesale level (paragraph 1.37). The new migration charges stand in stark contrast to the amounts which BT was required to pay in order to set up the initial installation (i.e. £49-£117 depending on when the installation took place and whether it was an engineer or self install). BT is clearly at a relative disadvantage, given that it is required to recover the upfront cost, while other CPs can migrate at a cost of just £11.

4.53 Overall, therefore, BT's competitors are able to upgrade and acquire new fibre customers at a lower cost than BT has faced to date.

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[38] Dido Harding: "*although the gross margin on fibre is lower in the percentage level than copper, fibre customers are a lower cost to serve and lower churning*". Interim 2012 TalkTalk Telecom Group PLC Earnings Conference Call, 13 November 2012. See further Section 8 below on churn.

[39] http://help2.talktalk.co.uk/how-setup-or-check-your-talktalk-super-router-connection

4.54 Moreover, the <u>incentive</u> of CPs to upgrade to fibre has recently increased following Ofcom's decision in the FAMR Statement to reduce the LRIC differential between WLR+SMPF and MPF wholesale inputs. This development reduces the artificial cost advantage previously enjoyed in the provision of copper broadband by MPF providers such as Sky and TTG over BT.

4.55 As Ofcom notes at paragraph 16.18 of the FAMR Statement:

> "*[…] these charge controls will benefit consumers by […] enabling CPs to make efficient choices between the substitute WLR+SMPF and MPF wholesale inputs, based on their LRIC differences. <u>These controls will promote efficient NGA choices</u> on the part of both BT in investment in infrastructure and services and of other CPs on the choice of wholesale inputs and associated investment to support retail fibre provision during the period of technology change*"

4.56 BT considers that it is important that Ofcom allows sufficient time for the incentive structure it has recently put in place to take hold rather than prematurely seeking to overlay further regulation in the form of entry assistance in fibre broadband through control of the VULA margin.

<u>Infrastructure investments upstream will lead to greater retail competition</u>

4.57 In addition to increased offerings at the retail level, it is also clear that substantial investments are being made upstream by other networks in order to enable retail operators to provide compelling SFBB propositions. This level and variety of infrastructure investment is evidence of the vibrancy of opportunities to compete in the supply of SFBB products. This further highlights the importance of Ofcom exercising caution in making predictions as to future market developments and the need for it to be sure that there is sufficient evidence of potential harm in order to justify at this stage the imposition of additional ex ante regulation.

4.58 For example:

(a) In August 2014, **Virgin** announced the largest expansions of its network since the company launched in 2007. It plans to make its network available to 100,000 further homes in East London. In its press release, Virgin notes that its customers will benefit from broadband speeds of up to 152Mb, "*far ahead of BT or any other major provider*".[40] Virgin has also announced plans to expand its network in Cambridgeshire.[41]

(b) **CityFibre** is a joint venture established by Sky and TTG with the intention of offering speeds of up to 1Gbps to consumers. While currently focussed in York, rollout could potentially expand to other cities, reaching a footprint of up to 3 million households in the coming years. TTG in its preliminary results for the 12 months to 31 March 2014 noted as follows: "*We intend to bring ultrafast broadband to two further cities in due course and are excited by the long term potential for a <u>national roll-out</u>.*" (emphasis added) Dido Harding

[40] http://about.virginmedia.com/press-release/9444/virgin-media-takes-superfast-broadband-to-east-london

[41] http://www.ispreview.co.uk/index.php/2014/08/virgin-media-expand-uk-network-cambridgeshire-village-fttp.html

added as follows: "*there are roughly 10m households living in tier 2 cities in the UK, so if the trial in York works, we would see the potential to scale across nearly 50% of the UK*".[42]

(c) Separately and in addition to its CityFibre joint venture, **Sky** has indicated that it wants to build its own fibre-optic broadband network. For example, in Basingstoke, Sky is building its own FTTP network capable of delivering speeds of up to 950 Mbps over an ethernet connection (150 Mbps over WiFi).[43]

(d) **Hyperoptic** is rolling out a 1Gbps-capable FTTH network across big residential and office buildings in the UK cities of London, Cardiff, Bristol, Reading, Manchester, Liverpool and Leeds. It has promised to cut the price of their "*hyper-sonic*" packages in half for the first 6 months of service. At present Hyperoptic's network has managed to reach around 35,000 homes, spanning over 150 major property developments (mostly in London but now being expanded to the other cities), and they intend to hit a long-term goal of 500,000 premises by 2018.[44]

(e) **GTC** launched its 300Mbps FTTH network, which will become their standard technology of choice across all future new build homes in the United Kingdom. GTC, which works alongside house builders to roll-out gas, electric, water and Internet connectivity into various new builds across the country, has already conducted some FTTH deployments in Upper Heyford and at a few other developments. The provider has also recently signed a TV content deal with Sky.[45]

(f) **Gigaclear** has secured private investment to help fund the next phase of its growth and a roll-out of 1Gbps-capable Internet access into more areas, which could reach 15,000 premises by the end of 2015 and go much further in the future.[46]

(g) **Google** is understood to have held talks with CityFibre over bringing the Google Fibre project to the UK.[47] Google Fibre currently operates in four US cities and plans to expand to a further 34 cities.

(h) **GEO Networks** (part of Zayo Group), a dedicated fibre optic solutions provider for the United Kingdom, recently acquired around 1,000 miles of

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[42] Preliminary 2013/14 TalkTalk Telecom Group PLC Earnings Conference Call, Thomson Reuters Transcript, 15 May 2014.
[43] http://www.engadget.com/2014/06/25/sky-gigabit-fiber-network-trial-basingstoke/
[44] http://www.ispreview.co.uk/index.php/2014/06/uk-isp-hyperoptic-launch-half-price-1000mbps-home-broadband-service.html
[45] http://www.ispreview.co.uk/index.php/2014/06/uk-utility-provider-gtc-launch-300mbps-ftth-broadband-standard.html
[46] http://www.ispreview.co.uk/index.php/2014/07/gigaclear-target-50000-uk-rural-homes-1gbps-fttp-broadband-2015.html
[47] http://www.ispreview.co.uk/index.php/2014/07/google-ponders-building-uk-fibre-optic-isp-broadband-network.html

fibre optic cabling in South Yorkshire, which used to belong to the now defunct Digital Region (DRL) broadband network, for an undisclosed sum.[48]

External CPs' share of VULA net adds will continue to grow

4.59 In spite of the diverging commercial strategies taken by various CPs to date, BT's share of fibre net adds has, considered in the round, been falling over time, as other CPs have chosen to sell SFBB products more actively. For example, in BT's latest results, it noted the latest retail and Openreach fibre net adds figures, as set out in the table below – just as a percentage of net adds on the Openreach network.

	2012/13				**2013/14**				**2014/15**
Net adds	**Q1**	**Q2**	**Q3**	**Q4**	**Q1**	**Q2**	**Q3**	**Q4**	**Q1**
BT retail fibre net adds	154	157	200	211	197	195	228	249	226
Openreach fibre net adds	170	186	245	271	265	316	339	347	341
Third party fibre net adds	16	29	45	60	68	121	111	98	115
%age of BT retail fibre net adds	**90.6**	**84.4**	**81.6**	**77.9**	**74.3**	**61.7**	**67.3**	**71.8**	**66.3**
%age of third party fibre net adds	**9.4**	**15.6**	**18.4**	**22.1**	**25.7**	**38.3**	**32.7**	**28.2**	**33.7**
%age of third party fibre net adds (annual average)	**16.4**				**31.2**				***N/A***

4.60 These figures clearly demonstrate the growing share of third party fibre net adds as a percentage of the Openreach total, starting at less than 10% in Q1 of 2012/13 and moving above 30% in 2013/14 and beyond. Moreover, the latest available data shows that [ ]. CONFIDENTIAL

4.61 In fact, the position with respect to acquisitions only (i.e. removing regrades by CPs of their own copper customers to SFBB) [ ]. This clearly demonstrates that there is increasingly vibrant competition, both for new SFBB customers and for existing SFBB customers from other CPs. CONFIDENTIAL

4.62 Finally, looked at more properly in terms of the overall picture for the supply of high speed broadband, it is even clearer that BT's position is far less entrenched than Ofcom considers. For example, as late as the end of Q1 2014/15, BT's share of overall high speed broadband was just 30%, similar to BT's overall broadband market share.

[48] http://www.ispreview.co.uk/index.php/2014/07/geo-networks-uk-acquires-digital-regions-remaining-fibre-optic-assets.html

Fibre base by provider (000)	Q1 11/12	Q1 12/13	Q1 13/14	Q1 14/15
BT Infinity	177	607	1,305	2,159
Virgin	4,048	4,152	4,306	4,415
TTG	1	15	95	241
Sky	0	9	98	298
Total	4,226.6	4,783	5,804	7,113

4.63 These figures present stark evidence that there are no competition or entry problems in the supply of SFBB products, even despite the divergent strategies taken to date by BT, Virgin and other CPs. On a dynamic view of the market, BT's share of net adds is likely to fall even more rapidly as CPs increasingly promote fibre broadband.

4.64 As set out in further detail in Section 5 below, Ofcom's analysis and conclusions in relation to BT's forecasts (see, for example, paragraph 3.69 of the Consultation) is, therefore, overly simplistic. Ofcom has not properly examined and interrogated the available data from all CPs.

Current SFBB subscription rates (and BT forecasts made at a point in time) are therefore not representative of potential future rates

4.65 Overall, it is evident that BT's share of VULA net adds has been steadily declining and is set to be put under further pressure from the increasing promotion by other CPs. Importantly, these trends are likely to increase further over the current market review period as CPs' strategies evolve and they increase advertising. In addition:

(a) TTG and Sky, in particular, are now well-placed to promote fibre among their substantial copper broadband bases of approximately 4.2m and 5.2m, respectively. Importantly, Sky and TTG's bases are also heavily skewed towards urban consumers where they can be readily connected to the Openreach network or to alternative platforms such as the Sky / TTG CityFibre network described at paragraph 4.57 above.

(b) It is also important for Ofcom to recall that at present BT's share of SFBB expressed in terms of homes where the Openreach fibre network has been deployed stands at just over 10%.[49] There is therefore clearly huge scope for TTG, Sky and other CPs dramatically to increase their existing shares of fibre broadband.

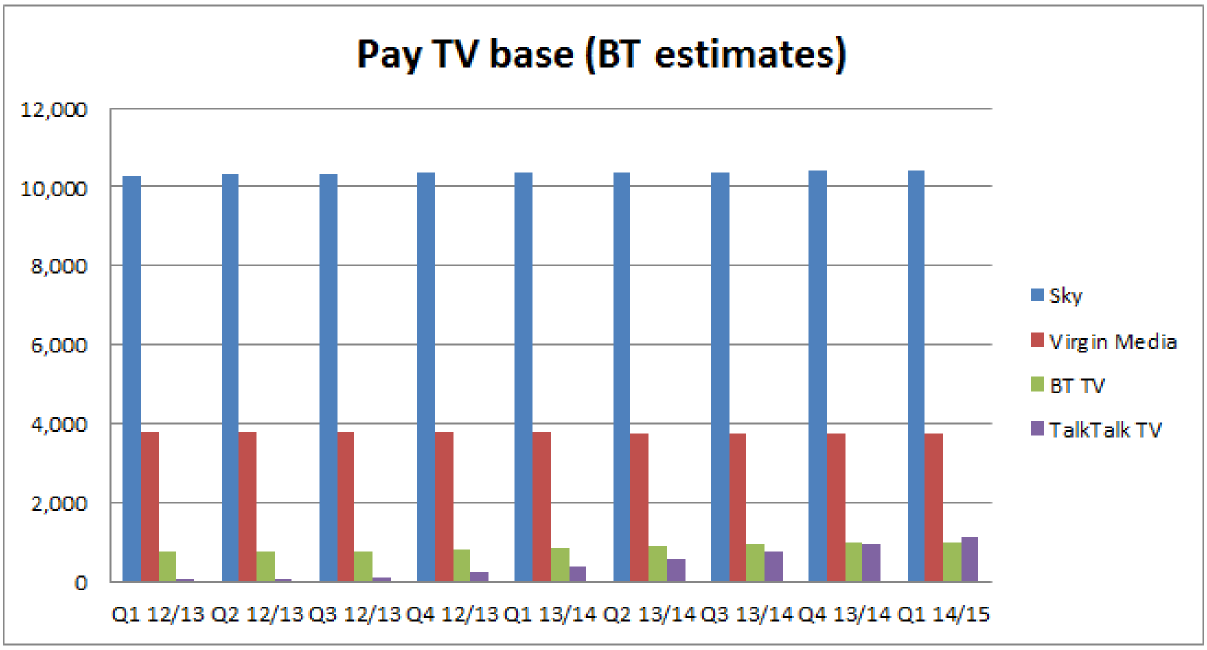
4.66 Ofcom also neglects the fact that BT's overall share of SFBB connections in the overall broadband market is still dwarfed by Virgin. Even if Ofcom does not consider that Virgin, alone, would be a sufficient constraint on BT's behaviour, it must still take it into account in its analysis both of whether there is justification to impose an MST at all, and whether the particular test proposed is proportionate, neither of which has Ofcom sufficiently done. Both on a static and dynamic analysis, Virgin operates as a major competitor to BT.

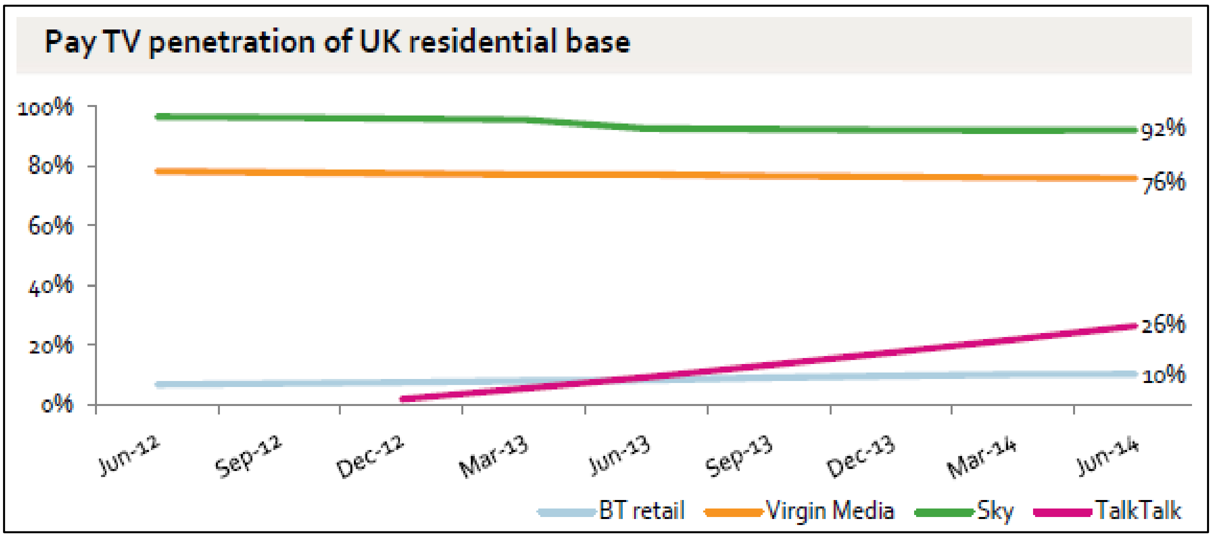
[49] Calculated based on BT's closing base in Q1 2014/15 of 2.1m and estimated number of homes with access to the Openreach fibre network of approximately 20m.

Competition in the provision of broadband in triple-play bundles is driven by the terms by which CPs can access key channels to support their pay TV offerings

4.67 In Figure 1.10 of the Consultation, Ofcom notes that about one fifth of customers now buy bundles of fixed voice, broadband and multichannel TV services.

4.68 However, Ofcom fails to recognise that BT's position in the supply of triple-play is very different to that of its principal competitors. In particular, BT's ability to compete more effectively in triple-play is impacted by disadvantageous access to sports content. As a result, BT's share – expressed both in absolute terms and as a proportion of the residential base – is less than each of its principal competitors. This is set out in the charts below.





Source: Enders Analysis, *UK broadband, telephony and pay TV trends Q2 2014*

4.69 In its Pay TV Statement[50], Ofcom set out a detailed assessment of Sky's dominant position in the wholesale provision of Core Premium Sports Channels ("**CPSCs**"). Ofcom made clear in the Pay TV Statement that it considered Sky would maintain its dominant position in the wholesale provision of CPSCs provided that Sky retained the 'majority' Football Association Premier League ("**FAPL**") rights.[51]

4.70 Ofcom also considered the importance of aggregation of a range of content in the Pay TV Statement. It is notable in this respect that since 2010, Sky has acquired important additional premium sports rights, in particular Formula 1 and live US Masters golf rights. Formula 1, in particular, has further strengthened Sky's position. Other than UCL, Sky has retained all of the major rights, as well as a larger number and proportion of FAPL rights, than when Ofcom carried out its assessment in 2010. As noted by Enders, Sky Sports channels remain and will for the foreseeable future remain the "*must have*" CPSCs[52].

4.71 As submitted by BT in the context of its ongoing complaint to Ofcom regarding the wholesale supply of Sky Sports[53], Sky will continue to be the dominant wholesaler of CPSCs – and the outcome of the 2013 UCL and UEL Auctions did not alter the assessment. As noted above, Sky has in fact further strengthened its CPSC offering in important respects since the Pay TV Statement in 2010.

4.72 Notwithstanding Sky's dominant position, BT has been unable to access Sky's sports content on its strategic YouView platform, which Ofcom has previously stated is essential to be able to compete. In contrast, Sky has notably provided access to its sports content, as well as its other premium and basic channels, to all of BT's principal competitors, but refuses to grant BT access on fair and reasonable terms.

4.73 As a result, BT is at a severe disadvantage in competing for customers that place a high value on sport, predominantly against Sky, but also (albeit to a lesser extent due to the nature of Sky's wholesale rate-card pricing) against Virgin and TTG, both of which have access to Sky's CPSCs, and the full range of Sky's sports channels, including in HD as well as SD.[54]

4.74 Unless and until effective regulatory action is taken to address the terms on which Sky provides access to its CPSCs, BT will remain at a significant disadvantage in providing pay TV – and therefore triple-play – offerings. In addition, even if an effective sports remedy was implemented, BT would remain at a disadvantage, since, unlike its principal competitors, BT also does not have access to the full range of Sky's basic channels.

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[50] Ofcom Pay TV Statement, (31 March 2010).

[51] Pay TV Statement, paragraph 5.493.

[52] "*Sky Sports [still is and in late 2015 still be] the must have and BT the junior partner in the pay-TV duopoly*", see Enders Analysis: "*BT Sport Euro football winner – what a price!*" (12 November 2013), page 3.

[53] See CW/01106/05/13 - *Complaint from British Telecommunications plc ("BT") against British Sky Broadcasting Group plc alleging abuse of a dominant position regarding the wholesale supply of Sky Sports 1 and 2*.

[54] See, for example, Sky's recent announcement that Sky Sports channels would be available free on 16 August 2014 to all Sky, Virgin and TTG customers: '*Sky Sports free to Sky, TalkTalk and Virgin Media customers for Premier League first day*', Pocket-lint, 12 August 2012.

4.75 The impact of these issues on Ofcom's treatment of BT Sport within its proposed MST is addressed in Section 7 below and Annex C.

Conclusions

4.76 This Section sets out in detail the evidence which BT submits Ofcom would need to take into account before reaching any conclusion on the need for an ex ante MST. In particular, the evidence shows that the broadband market (including in relation to SFBB) is highly competitive, served by a number of large well-resourced companies with differing commercial strategies and incentives.

4.77 This Section also provides the relevant context for BT's assessment of Ofcom's overall regulatory aim and its consideration of the options for achieving that aim, to which we turn in the following Section.

5. Ofcom's overall regulatory objective

Introduction and Summary

5.1 In Section 3 of the Consultation, Ofcom considers its overall regulatory objective by first establishing its overall aim – to ensure BT does not abuse its SMP in VULA to distort competition in SFBB services – and then considering its options for best achieving this aim.

5.2 Ofcom concludes by proposing that the best means of ensuring BT does not distort competition in SFBB services is 'Option 2' – i.e. *"to ensure that BT does not set the VULA margin such that it prevents an operator that has slightly higher costs (or some other slight drawback relative to BT) being able to profitably match BT's retail superfast broadband offers".*

5.3 The analysis and reasoning Ofcom sets out in Section 3 in proposing to adopt Option 2 as the best means of achieving its overall aim are of central importance to the overall approach Ofcom proposes to take in the Consultation. Ofcom's decision is based on the following analysis:

(a) Consideration of the risks of distortion, focussing on (i) the perceived importance of the current market review period and (ii) the risks to effective retail competition;

(b) Whether BT has the ability and incentive to undermine competition during this market review period;

(c) How retail competition in the provision of SFBB services is expected to develop in this market review period; and

(d) Consideration of different options for achieving the overall aim, including an analysis of the trade-off of effectiveness and costs in choosing between its various options.

5.4 BT considers that Ofcom's analysis in Section 3 is inadequate and wholly insufficient as a basis on which to adopt Option 2. Crucially, Ofcom's analysis is not based on any firm conclusions as to whether the evidence it cites (in particular, BT's current share of VULA net adds and forecast share during the market review period) is, or may be, the result of BT adopting margin squeeze strategies which place competitors at an unfair disadvantage and, therefore, distort competition. By failing to establish a specific 'problem' with the way current broadband providers are able to compete with BT's SFBB offers, Ofcom provides no basis for framing Option 2 in the way proposed.

5.5 This choice is also of critical importance given that Ofcom proceeds to design a new regulatory remedy building directly upon the general wording of Option 2. For instance:

(a) As a result of its decision to protect CPs with "*slightly higher costs*" than BT, Ofcom proposes to adopt an adjusted EEO standard.

(b) Its decision to ensure that CPs must be able to "*profitably match BT's SFBB offers*" directly influences its simplistic decision in Section 5 of the

Consultation to include BT TV and BT Sport within the scope of the proposed test. However, in adopting Option 2 in the first place, no consideration at all is given at all to the relevance of the way BT provides BT TV and BT Sport to competition within SFBB.

(c) Finally, ensuring that CPs can "*profitably match BT's SFBB offers*" also appears to have a direct bearing on Ofcom's proposals in Sections 5 and 6 of the Consultation to implement a 'bright line' test with no separate consideration of distortive effects.

Ofcom's overall aim in regulating the VULA margin

5.6 Ofcom begins by setting out the legal framework sitting behind its regulatory aim. We address the points considered in this sub-section in Annex B.

5.7 At paragraph 3.38, Ofcom defines its overall regulatory aim as being:

> "*to ensure that BT cannot use its SMP in the WLA market to set the VULA margin over the period of the market review such that it causes retail competition in superfast broadband to be distorted*".

5.8 BT does not challenge the general regulatory aim, but fundamentally disagrees with the proposed <u>means</u> by which Ofcom seeks to achieve this aim.

Risks of distortion to competition

5.9 Ofcom considers that there are two elements which explain why it needs to ensure sufficient retail competition <u>in the provision of SFBB</u> (paragraph 3.40):

(a) The future role of SFBB, given its view that the next three years will be an important period in the transition from SBB; and

(b) The risks posed to effective retail competition in the short and long term.

5.10 Again, while we do not disagree in principle with Ofcom's largely theoretical assessment of the <u>potential</u> risks of distortion, we do consider that Ofcom's high level analysis in paragraphs 3.40-3.54 leads it to draw the wrong conclusions in the remainder of Section 3.

<u>Role of the current market review period</u>

5.11 Ofcom considers (at paragraph 3.43) that the period covered by this market review is likely to be important in determining whether effective competition in SFBB emerges, primarily for two reasons:

(a) Ofcom expects this review period to be important for take-up of these services (paragraph 3.44); and

(b) This period represents a disruption to the market, presenting an opportunity for retailers to win customers from rivals (paragraph 3.45).

5.12 Ofcom relies heavily on forecasts gathered during the market review to support its conclusion that the number of SFBB subscribers is likely to grow significantly to 2017 (see further paragraphs 5.31-5.38 below). However Ofcom ignores the fact that even BT's second forecast (provided to Ofcom in February 2014) anticipated total

NGA connections of [ ], representing less than [ ] of overall broadband subscribers. It is therefore clear that even by 2017, SFBB subscribers are still forecast only to represent a distinct minority of overall broadband subscriptions. CONFIDENTIAL

5.13 In terms of disruptive market effects, Ofcom considers that it is "*plausible*" that a consumer switching from SBB to SFBB will be more willing to consider an alternative provider. No evidence is provided to support this claim. In contrast to Ofcom's assertion, it is equally "*plausible*" that a consumer would wish to remain with its current provider when moving from SBB to SFBB. For example, this would enable a direct comparison on a like for like basis of the differences in quality between the two services. Indeed, as noted in Section 4, a large majority of BT's SFBB subscribers came from its copper base and Ofcom recognises that other CPs may be behind BT in their upgrade strategies (see paragraph 3.62), although this has not been investigated by Ofcom.

5.14 In short, while BT does not dispute that the current market review period may be "*important*" per se, Ofcom has not demonstrated why this period is of particular importance in the context of its consideration of the key issue in this Consultation – i.e. whether a new SMP condition is required.

5.15 In this context, BT refers Ofcom to the market context set out in Section 4 which considers the different strategies operators are adopting in competing for broadband customers. While TTG and Sky have not until recently heavily promoted their SFBB services 'above the line', they remain strong competitors in the overall broadband market as a result of their SBB services. They offer SFBB services at competitive prices and claim these are profitable. Their sales of SFBB services during the market review period can be expected to increase and they may choose to more actively upsell SFBB to their substantial bases and/or compete for triple-play bundles where they both have advantages over BT.

The risks to effective retail competition

5.16 In paragraph 3.47, Ofcom sets out a theoretical construct of the way in which a vertically integrated operator with SMP upstream could use its market power to distort competition downstream. In particular, it notes that the operator (in Ofcom's example, BT) could set its wholesale and retail prices such that there is an insufficient margin between upstream and downstream prices, thereby limiting the ability of other operators to match the dominant operator's retail offers. Ofcom considers that the impact of the margin squeeze would be that the SMP operator is more likely to retain its existing retail customers and win those of its rivals. If the SMP operator were to build up a substantial retail base, its position could endure in the long term, "*potentially resulting in a distortion to (and weakening of) retail competition that harms consumers*". Ofcom concludes that there is a risk of adverse effects arising from such a distortion.

5.17 BT does not dispute the theoretical construct described above. However Ofcom fails to apply the facts correctly to the theoretical problem statement – both here and in its later analysis. In particular, in paragraph 3.48:

(a) Ofcom states that BT may obtain first mover advantages over its rivals. However, this should not be a reason to penalise BT, unless Ofcom can demonstrate that any supposed advantage has been gained on the back of a market distortion – which is patently not the case. Ofcom's precautionary approach risks creating a 'hold up' problem and sending strong negative signals to industry participants, thereby dampening incentives to make future pro-competitive investments.

(b) Ofcom notes that adverse impacts on rivals may be compounded if there are significant customer switching costs, yet neglects to note that it has taken action in this very area in the recent FAMR Statement when it reduced the CP to CP GEA migration charges substantially. This is described further in Section 4.

(c) While other CPs currently have lower existing SBB subscriber bases than BT, these are still substantial. Sky's base stands at over 5m customers and TTG's is over 4m, representing an enormous upgrade opportunity for those providers. Importantly, Sky and TTG's bases are also heavily skewed towards urban consumers where they can be readily connected to the Openreach network or to alternative platforms such as the Sky / TTG CityFibre network described in Section 4 above.

5.18 In terms of the timing of any alleged consumer detriment, Ofcom concludes that some of it is likely to be felt after the current review period. However it also notes a number of potential short term effects which could arise before 2017. For example, Ofcom postulates that BT could (paragraph 3.51): (i) unduly raise its wholesale prices; (ii) stifle the ability of rivals to compete in terms of price structures, innovation, marketing and efficiency; and (iii) cause significant consumer detriment were the SBB and SFBB markets to separate during the next three years.

5.19 However such concerns are purely speculative and not evidenced or interrogated by Ofcom to the requisite standard:

(a) In terms of the first concern, Ofcom has recently in the FAMR Statement decided against implementing a price control on GEA. Moreover, in relation to any potential concerns about future pricing, Ofcom already has the power to control the absolute level of BT's wholesale prices, both through the existing FRAND SMP remedy and competition law which prevent excessive pricing. Ofcom has not sufficiently recognised the deterrent effect of the need to comply with these provisions on BT, but in any event, even if BT did attempt to impose a price squeeze in the face of these provisions, they would be effective to prevent it from doing so.

(b) The second and third concerns are completely unfounded given that Ofcom notes elsewhere in the Consultation (paragraph 3.77) that BT's rivals are likely to have their own advantages over BT, enabling them to compete effectively. In addition, the available evidence led Ofcom to conclude in the WBA Statement that there would remain a single broadband market until 2017. For Ofcom to reverse its conclusion would entail a further review, in which it would be obliged to reappraise the appropriateness of the SMP remedies in place.

5.20 There is therefore nothing in Ofcom's assessment which points to a need to act now, in the course of the current review period, to place a major additional restriction on

BT's commercial freedom beyond the constraints already imposed by FRAND and/or competition law. These issues are considered further in Sections 6 and Annex B.

BT's ability and incentive to undermine competition

5.21 In paragraph 3.61, Ofcom concludes that BT has the ability and incentive to use its SMP in the WLA market to set the VULA margin such that it causes retail SFBB competition to be distorted. Its analysis appears to rely on the following foundations:

(a) BT's position as a vertically integrated firm with upstream dominance gives it the ability to raise its rivals' costs, which would both restrict their ability to compete in the short term and signal that BT would 'punish' rivals that competed too aggressively (paragraph 3.57);

(b) The threat that BT might set a low VULA margin could undermine rivals' incentives to expand as strongly in SFBB (paragraph 3.59);

(c) Raising the VULA price – or even having the ability to do so – may be a low cost way for BT to impede retail competitors (paragraph 3.60).

5.22 BT considers that Ofcom's analysis of ability and incentive is inadequate.

5.23 First, Ofcom's points on BT's ability to distort competition by effecting a margin squeeze are clearly made under the assumption of there being no regulatory constraints in place. As noted in Section 2 however, the key issue in the Consultation is to consider the need for an additional SMP condition and, therefore, the efficacy of the existing remedies in preventing distortion of competition in SFBB services. BT's position is that any theoretical ability to increase VULA prices or reduce retail prices such as to distort ability of others to compete profitably is already addressed by competition law and the FRAND SMP condition. Indeed Ofcom introduced the FRAND condition in the 2010 FAMR Statement having noted that it would be "*concerned if wholesale VULA prices appeared to be unfair, relative to the prices (after discounts) of BT's downstream products*".[55]

5.24 BT notes that Ofcom does not deal specifically with BT Sport when discussing ability and incentive. For the avoidance of doubt, BT considers that BT Sport does not give it the ability to exclude or marginalise its competitors, for the reasons set out in Section 7 below and in the Compass Lexecon paper enclosed at Annex C.

5.25 Second, Ofcom has not shown that BT has the incentive to undermine competition. The standard economic logic for exclusion in a vertical chain is that by pricing at an inappropriately low price a firm can (i) 'steal' their competitors' downstream sales and (ii) having excluded downstream rivals, subsequently increase downstream prices. However, Ofcom's analysis is insufficient on this point and fails to recognise the following:

(a) Section 2 described the stylised 'plain vanilla' case where the vertically integrated firm would have an incentive to exclude competitors by limiting the margin available. But once the conditions of supply and demand differ from those in the stylised 'plain vanilla' case, as they very clearly do in relation to

[55] WLA Statement 2010, paragraph 8.131.

the provision of bundles including BT TV and/or BT Sport, then the incentive to implement exclusionary margin squeeze strategies is far from clear. Moreover, given the current levels of differentiation between broadband providers, there would be no guarantee that BT would acquire any consumers lost by its competitors as a result of marginalisation or exclusion.

(b) As noted above and recognised by Ofcom, the prices of SFBB services are currently constrained by cable offerings and products based on traditional copper access products. Therefore, for at least as long as this remains the case, BT could not profitably raise its retail price, even in the unlikely event that it were to exclude or marginalise downstream competitors from using its NGA network.

(c) It is in BT's interests overall to ensure that the Openreach network is utilised as fully as possible – see Section 4 above. Given that other CPs (in particular Sky) are able to differentiate their SFBB offerings, particularly through bundling with other services that may be superior to those that BT can itself offer, this will consequently attract customers that BT would not otherwise attract. Excluding third party competitors at the downstream level would therefore be likely to lose BT significant wholesale sales.

5.26 Indeed, Ofcom itself recognises many of these factors in its FAMR Statement. In response to putative concerns regarding BT's ability and incentive to set excessively high VULA prices, Ofcom considered them to be unlikely for the following reasons (paragraph 12.135):

(a) the retail price of SBB will act as a constraint on the retail prices that can be charged for retail products that use VULA;

(b) if an excessive VULA charge results in retail prices for SFBB that are too high, then consumers are more likely to continue to use SBB rather than upgrade to SFBB. This could make it more difficult for BT to recover its investment in SFBB, thereby acting as a similar constraint on retail prices that can be charged for services based on VULA;

(c) Virgin's SFBB services are also likely to exert a constraint on the retail prices of products that use VULA, over and above the constraint from copper broadband.

<u>Importance of Virgin</u>

5.27 At paragraph 3.56 of the Consultation, Ofcom largely rejects the importance of Virgin, in part because it "*only covers approximately half of premises*". However, Ofcom fails to recognise that there is a large degree of overlap between Openreach's fibre network and the premises which Virgin serves. Outside of Virgin's footprint, a large part of Openreach's fibre network has already or will be deployed as part of the BDUK framework, which has separate rules, including the option to use Physical Infrastructure Access (PIA).

5.28 Importantly in this respect, Virgin represents a strong competitive restraint on BT's SFBB offerings and it has a clear impact on BT Consumer's broadband net adds. For example, [CONFIDENTIAL [redacted]] This trend has been seen historically in areas with and without VULA availability, although the presence of VULA does offset some of the impact of competition from Virgin's offering.

5.29 Ofcom's sole focus on VULA net adds, to the exclusion of Virgin, in arriving at its conclusions in Section 3 of the Consultation is flawed, ignoring obviously relevant market data. Ofcom's scant assessment therefore risks ignoring a key competitive driver in the supply of high speed retail broadband.

5.30 Considered in the round, it is therefore clear on a proper analysis that BT has neither the ability nor the incentive to "*undermine*" competition, as Ofcom allege. Ofcom's provisional conclusions are not, therefore, consistent either with the evidence or the appropriate legal standard.

<u>Treatment of BT's forecasts</u>

5.31 At paragraphs 3.61-3.69, Ofcom relies heavily on BT's forecasts to support its view that regulatory intervention is justified in order to address its concern that BT has ability and incentive to use its SMP in the WLA market to set the VULA margin in this review period such that it causes retail competition in SFBB to be distorted.

5.32 However, for the reasons set out in Section 4 above, the speculative concern described by Ofcom in the Consultation is not based on a full analysis of the available evidence. In addition, it is clear that Ofcom has placed significant weight on BT's forecasts while apparently largely ignoring those from other CPs, or at best relying on out of date material.

5.33 Ofcom has not sought to understand the evidence underlying the forecasts and has not assessed the full context in arriving at its conclusion that BT's forecast shares for the supply of fibre broadband point to a potential problem that needs to be addressed by intrusive regulatory intervention. Ofcom is in danger of misinterpreting such data as evidence of insufficient margin, resulting in a proposed solution which merely provides extra margin to CPs who do not, on any proper analysis, need such assistance.

5.34 In order to justify the additional regulation proposed in the Consultation, Ofcom should conduct a fuller examination of each CP's individual forecasts and strategies to gain a clear, comprehensive understanding of the relevant market dynamics. Reliance on forecasts from a single operator (which is itself reliant on old forecasts provided by other providers), without assessing in detail the relevant market context, would not be an appropriate basis on which to found Ofcom's proposed regulation.

5.35 Moreover, as noted by BT in its response to Question 1.1 of the 13th section 135 notice of 12 February 2014 – on which Ofcom places heavy reliance – the forecasts were "*based on a combination of current performance trends and <u>aspirational targets</u>*" (emphasis added). Ofcom cannot rely on such forecasts as the primary foundation on which to introduce the stringent and wide-ranging MST proposed.

5.36 Without gathering updated information on CP fibre forecasts and strategies, as well as conducting a full assessment of that information, Ofcom is not in a position to reach any final, robust conclusions. In this regard, BT notes that based on the information set out on Annex 7 of the Consultation, Ofcom appears to have gathered scant information from CPs apart from BT in this area.

5.37 Notwithstanding these evidential concerns, BT notes that Ofcom goes on to state at paragraph 3.69 that:

> "*We recognise that BT winning a high share of VULA-based superfast broadband subscribers could reflect the legitimate rewards of competition. However, we would be concerned if it were instead a consequence of BT exerting its SMP in the provision of WLA to supply VULA on terms that do not allow other operators to compete effectively*." (emphasis added)

5.38 In other words, Ofcom is conceding that the forecasts themselves do not reveal the existence of a current competition problem due to BT adopting price squeeze strategies for its SFBB offers or even that there is heightened risk of BT doing so during this market review period. As such, Ofcom is arguably just re-stating the importance of its general regulatory aim – i.e. the need to prevent distortion as a result of BT's SMP in WLA. The focus should remain on that overall aim, therefore, when considering the merits of the different options.

Assessment of options to achieve Ofcom's regulatory aim

5.39 As noted above, BT does not object in principle to Ofcom's overall aim, i.e. ensuring that BT does not abuse its SMP in VULA so that retail competition is not distorted. Instead, BT's concern is that the means adopted to achieve that aim are not proportionate.

5.40 In order to achieve its stated aim, Ofcom identifies three potential options:

(a) Option 1 – ensure that BT does not set the VULA margin such that it prevents an operator with the same costs as BT being able to profitably match BT's retail SFBB offers.

(b) Option 2 – ensure that BT does not set the VULA margin such that it prevents an operator that has slightly higher costs than BT (or some other slight commercial drawback relative to BT) being able to profitably match BT's retail SFBB offers.

(c) Option 3 – ensure that BT does not set the VULA margin such that it prevents an operator that has slightly higher costs than BT (or some other slight commercial drawback relative to BT) being able to profitably significantly undercut BT's retail SFBB offers.

5.41 Ofcom dismisses Option 1 as not being sufficient to promote retail competition in SFBB (paragraph 3.79) in light of its (inchoate) analysis of the retail market. It also considers that the incremental effectiveness of Option 3 over Option 2 may be relatively low as it is questionable whether CPs require (even greater) additional margin in order to compete effectively (paragraph 3.82). Ofcom therefore concludes that Option 2, entailing entry assistance, would best achieve its aim.

5.42 BT makes two immediate points in relation to the Options identified by Ofcom:

(a) As framed, all options risk immediately losing focus on Ofcom's stated overall aim – i.e. to prevent BT distorting SFBB competition. A proportionate test would be concerned with preventing pricing behaviour that would likely have exclusionary effects in the market, whilst at the same time ensuring that pricing behaviour that would not be likely to have such effects is not prohibited. Instead, the focus is simply on BT maintaining a specific level of VULA margin that will allow BT's competitors to match or beat BT's retail prices. The risk is therefore that Ofcom has set up an approach that inevitably leads to a 'bright line' test of BT's margin based on BT's costs and revenues (possibly adjusted). This risk is compounded by the general reference to "*BT's retail superfast broadband offers*" which is subsequently interpreted to cover all offers including bundles with BT TV and/or BT Sport. The risks and difficulties of including these services within any 'bright line' test of BT's prices and costs are considered in more detail in Section 7 below.

(b) Ofcom's assessment of these different options essentially amounts to a consideration of whether, in considering margin squeeze issues, Ofcom should take an EEO approach or some other adjusted approach. While the issue is revisited in Ofcom's Section 5, it has arguably already been closed down as a separate issue for consideration once the "*slightly higher cost*" benchmark operator has been chosen.

5.43 In the paragraphs below, BT shows that:

(a) The way in which Ofcom took its decision to effectively adopt the adjusted EEO approach on the most appropriate Option was procedurally flawed, in that it failed at that stage to take the utmost account of the Costing and Non-Discrimination Recommendation which, in essence, recommends that NRAs should, in determining the shape of any ex ante MST, depart from competition law principles, in particular the use of the EEO benchmark, only in very limited circumstances and to very limited extents;

(b) As a result of the flaws in Ofcom's analysis of the state of competition in downstream markets, Ofcom's reasons for rejecting Option 1 and choosing Option 2 are not clear and are unsustainable on the evidence; and

(c) Ofcom has failed to adequately assess the impact of its choice of Option 2 on its conclusions elsewhere in the Consultation.

Ofcom's approach to its choice of Option 2 is procedurally flawed

5.44 The approach taken by Ofcom in deciding to choose Option 2 is flawed in that it appears that Ofcom considered the options open to it (Options 1 to 3) without at that stage taking utmost account of the Commission's Recommendations and the BEREC Common Position. As presented in the Consultation (see Section 7), it appear that it was only after Ofcom had finally settled on the form of the test that it undertook this review of the Recommendations.

5.45 Ofcom should have considered those documents before settling on the most appropriate option. BT considers that if it had done so, Article 56 and Annex II of the Costing and Non-discrimination Recommendation would have reinforced the sufficiency of Option 1.

5.46 As set out in further detail in Section 3 above and Annex B, the triggers set out in Annex II for adjusting the EEO are as follows:

(a) that "*market entry or expansion has been frustrated in the past (as shown, for example by past behavioural findings)*". As made clear in Section 4, that is not the situation here. In addition, Ofcom's very recent provisional findings in its Competition Act investigation suggest exactly the opposite; or

(b) "*where very low volumes of lines* ***and*** *their significantly limited geographical reach as compared to the SMP operator's NGA network indicate that objective economic conditions do not favour the acquisition of scale by alternative operators*" (emphasis added). Ofcom has not demonstrated that this is the case in the UK. There are four significant market players, each operating at above minimum efficient scale in the retail broadband market and, as BT has shown above, the evidence does show that economic conditions <u>do</u> favour acquisition by all of them of scale in the supply of SFBB services. Although, at present, they have differing volumes of SFBB connections, this is not due to objective economic conditions but down to their strategic priorities (see Section 4 above) and they do already – or could readily if they so choose - have sufficient scale to compete effectively.

5.47 Indeed, even where adjustments to the EEO are justified (if one of the triggers above is met), they should not aim "*beyond that of a market structure with a sufficient number of qualifying operators to ensure effective competition*".[56]

5.48 The adjustments to the EEO that Ofcom propose – which result directly from its choice of Option 2 – go far beyond what is contemplated in the Recommendation. In short, the evidence shows that in the UK there is already a market structure with a sufficient number of qualifying operators to ensure effective competition – and indeed, Ofcom's findings are that the retail market is competitive. BT's contention is that the only outcome which would be consistent with having the utmost regard to this part of the Costing and Non-discrimination Recommendation would be the conclusion that no adjustments to the EEO could be justified, or could be shown to be proportionate.

Ofcom's reasons for rejecting Option 1 and choosing Option 2 are not clear and are unsustainable on the evidence

5.49 Ofcom dismisses Option 1 extremely lightly and simply states at paragraph 3.78:

> "*<u>Although we have not compared other operators' overall costs with those of BT</u>, we have identified some slight disadvantages for rival operators relative to BT. This suggests that if BT were to set a VULA margin only at the level required to meet Option 1, it would likely hamper the ability of rival CPs to compete in the retail provision of superfast broadband in this review period*." (emphasis added)

5.50 Footnote 90 then only highlights "*evidence that some CPs <u>may</u> experience shorter ACLs*" and "*the <u>possibility</u> that, in the future, BT's estimated unit bandwidth costs are*

[56] Paragraph 65.

lower than those of other operators" (emphasis added). BT challenges both these specific points in Section 8 below when considering Ofcom's proposed approach to modelling. But it is notable that Ofcom has presented no link between the current level of margin available to CPs and their ability and/or incentive to more actively promote and provide SFBB services.

5.51 Moreover, the fact that Ofcom has not carried out any comparison of overall costs in order to identify whether BT's perceived advantages are compensated, or even outweighed, by advantages of other CPs means that Ofcom's assessment is clearly inadequate in the overall context of the Consultation and the importance the decision over the choice of options has on Ofcom's overall set of proposals.

5.52 We also note that at paragraph 3.80, Ofcom states:

> "*… there is a material risk that Option 1 would be ineffective at preventing a distortion to competition [as] … even in the presence of the price differences highlighted [i.e. lower charges from TTG] BT has been able to win a substantial share of VULA-based retail superfast broadband connections… and expects to build a substantial base… in the future.*"

5.53 However, on this point we refer back to Section 4 in highlighting the very different strategic approaches being pursued by operators in competing in the broadband market. Notably, TTG and Sky are choosing to use SFBB largely as a retention tool at present (though both have increased their above the line marketing more recently) and focus on offering lower priced copper SBB services as their main broadband service. There is no evidence that this is forcing them to lose market share in the overall retail market identified by Ofcom and, most importantly, no evidence that they are being harmed as a result of BT's pricing unfairly distorting competition. Indeed, Ofcom's provisional NGFA decision supports the conclusion that BT is competing on the merits and its contention that it should not be penalised as a result of pursuing a different strategy to that being followed by its successful and profitable competitors. As noted earlier, BT's retail strategy to promote actively SFBB sales to our existing SBB base was and remains an integral part of the BT Group decision to invest in SFBB capabilities.

5.54 The absence of a clear evidential basis on which to support Option 2 over Option 1 means that it is impossible for Ofcom to assume any net benefit will arise from pursuing its chosen objective. Instead, by requiring BT to earn additional margin ostensibly in order to 'promote' competition, Ofcom may in fact simply reduce BT's effectiveness in the market at a net cost to consumers with other operators continuing to pursue their strategies in the overall broadband market. Ofcom is under an obligation to weigh up the expected costs and benefits of the various options in ensuring that its proposed response is proportionate. These crucial issues are addressed further in Annex B.

The impact of Option 2 on investment incentives

5.55 At paragraph 3.92, Ofcom states that "*adopting an option which maintains the approach adopted in the 2010 WLA Statement is, subject to the extent of increase in the VULA margin, unlikely to have a material impact on investment incentives*". It concludes (at paragraph 3.92) that the choice of Option 2 is "*unlikely to have a significant negative impact on investment incentives in this review period*".

5.56 Although significant investment has already been made in the UK's fibre network by BT, the next phases of infrastructure development will require significant capital investment to support them, hence regulatory certainty remains a critical aspect of the regulatory framework. Investments such as vectoring and other performance enhancing technologies will have long pay back periods commensurate with the existing fibre case and we look to Ofcom to create a stable regulatory environment for such long term infrastructure investments to be made with confidence.

5.57 Ofcom has largely ignored these investments in the Consultation. Ofcom's obligations to take account of investment extend to safeguarding a proper return on investment, as well as protecting investment incentives going forwards. This is clear from Article 13(1) of the Access Directive and section 88(2) CA03. In failing to take proper account of these investments, Ofcom has concluded that a more onerous MST is required than is necessary to meet its objectives. See further Annex B.

5.58 Examples of recent and forthcoming investments by Openreach include:

(a) *Vectoring*: As a first significant step in its plans to increase the capability of its FTTC product to 100Mbps and above, Openreach commenced its first vectoring trial during 2013, followed by a second trial in 2014. Initial results are very positive with the majority of lines showing significant performance increases. Openreach also began the roll-out of vectoring-compatible and vector ready DSLAMs in 2013. However, the prospective cost of rolling out vectoring to all fibre cabinets is very high and hence it is crucial that there is regulatory certainty underpinning this investment and BT Group has an opportunity to recoup such investment.

(b) *Network Evolution*: As with vectoring, further significant capital investment is likely to be required to implement other fibre technologies as they mature and hence regulatory certainty will also be a key factor in supporting those investments in due course. Openreach is now progressing trials of innovative new technologies such as Fibre to the Remote Node (FTTRn)[57] as announced in August 2014, and is continuing to look at the potential for further trials of new technologies such as XG PON, G.fast and other VDSL acceleration technologies which will mature further, become more standardised and be likely to form part of the future development roadmap. A number of these are already being assessed in detail as possible upgrade paths for the Openreach NGA platform. Another recent example is reflected in the Single Order GEA (SOGEA) consultation where Openreach is consulting with industry on a new product proposal which will allow CPs to evolve and develop innovative digital voice solutions.

5.59 Finally, it should also be noted that Openreach is investing significantly and innovating to support an increased footprint in partnership with public bodies such as BDUK, all on an open access basis. Openreach have investigated a number of technical solutions to allow economic delivery of 24Mbps to as wide a geography as

[57] FTTRn is an innovation which is a hybrid of FTTP and FTTC whereby active electronics are moved closer to the end user than FTTC (the DP) and either VDSL or G.fast technology exploits the shorter copper final drop. Use of G.fast technology at the DP is still being standardised but could enable 300Mbps to 1Gbps connections. Alternatively use of VDSL at the DP could enable FTTC cabinets experiencing capacity issues to grow further.

possible. In addition, Openreach is pursuing a range of solutions to deliver at least 2Mbps to those areas where it is uneconomical to deploy NGA. The key extension solutions under investigation include Copper Re-arrangement, All in One Cab, ADSL Regenerator, VDSL extender, Wireless to the Cabinet and Wireless to the Premises. Needless to say, all these will require significant investment, resource and real innovation to bring about a successful outcome for the UK, and need to be supported by the correct light touch regulatory framework to allow Openreach sufficient flexibility to innovate and an opportunity to recoup its investment.

The impact of Ofcom's choice of Option 2 on its conclusions elsewhere in the Consultation

5.60 BT also considers that Ofcom's provisional decisions set out in Section 3 lead it to draw the wrong conclusions in relation to other key aspects of the Consultation, leading on the whole to an unduly precautionary and interventionist approach.

5.61 In particular, as a result of its decision to protect CPs with "*slightly higher costs*" than BT, Ofcom proposes to adopt an adjusted EEO standard. Its decision to ensure that CPs must be able to "*profitably match BT's SFBB offers*" directly influences its decision in Section 5 of the Consultation to include BT TV and BT Sport within the scope of the proposed 'bright line' test, with no separate consideration of effects.

5.62 This makes Ofcom's assessment of the costs and trade-offs of Option 2 at paragraphs 3.95-3.101 incomplete and insufficient. This exposes that once Ofcom has finalised its full set of proposals, it is necessary for Ofcom to conduct a separate and more complete impact assessment of its proposals. This assessment would need to factor in all the costs and risks arising as a result of constraining BT's competitive activity and assessing these against clearly identified benefits in terms of improved efficiency of competition. Ofcom has not carried out this exercise to the requisite standard to show that the MST proposed, and based on Option 2, is not disproportionate. See Annex B for further detail.

Conclusions

5.63 BT considers that Ofcom's analysis in Section 3 is inadequate and wholly insufficient as a basis on which to choose 'Option 2' as the best means of achieving its overall aim. It is notable that there is very little further evidence of competition in SFBB or SBB services in the Consultation other than the narrative set out in Section 3 and that the choice of Option 2 heavily shapes Ofcom's overall proposals to introduce a new additional SMP condition in the form set out. Ofcom must therefore factor in all relevant information on the market before establishing which option would best achieve the aim and conducting a full assessment of cost and benefits. BT refers Ofcom to Section 4 of this Response to understand the market context in which SFBB is being provided.

5.64 As a result of these concerns with Ofcom's analysis, BT's position is that Ofcom has not met the requisite legal standard, either in relation to Ofcom's purported evidence base or its selection of Option 2. See further Annex B.

5.65 Moreover, Ofcom's approach to choosing Option 2 as the basis for its regulatory approach is procedurally flawed and not consistent with taking the utmost account of the Costing and Non-discrimination Recommendation which states that such tests should only depart from competition law principles in limited circumstances.

6. Form of the VULA margin requirement and compliance monitoring

Introduction and summary

6.1 In Section 4 of the Consultation, Ofcom assesses regulatory options in light of the proposed conclusion at the end of Section 3 that its overall aim would best be met by adopting 'Option 2'.

6.2 Having first reviewed the position taken in 2010, which relied solely upon the FRAND SMP remedy, and its provisional conclusion reached in the 2013 FAMR Consultation to supplement that FRAND remedy with guidance, Ofcom provisionally concludes as follows:

(a) Competition law is unlikely to contain all the features of a margin assessment considered necessary to achieve Ofcom's aim;

(b) Ofcom should impose a new additional SMP condition to those currently imposed under the FAMR requiring BT to set the VULA charge so as to maintain a minimum VULA margin at prevailing SFBB retail prices, supplemented by guidance ("**Option B**"); and

(c) BT should provide the data necessary to monitor compliance with the proposed Option B remedy to Ofcom every six months so that Ofcom can conduct a high level assessment of the margin at six monthly intervals (Option (i)).

6.3 BT considers that Ofcom's provisional conclusions in relation to the adequacy of competition law and the proposed adoption of Option B are flawed. In particular, Ofcom's assessment of its regulatory options in the Consultation fails to consider the real trade-off that is implicit in its choice of Option B over Option A: i.e. Ofcom proposes a 'bright line' test within an SMP remedy that prioritises certainty over flexibility without considering the net impact on BT's ability to compete fairly in providing SFBB services in a range of bundles. Ofcom therefore fails to consider the impact Option A could have on the effectiveness of competition across markets and, over the long run, on consumers.

Overall comments on Ofcom's assessment of regulatory options

6.4 BT has a number of overarching concerns with Ofcom's approach in Section 4.

6.5 First, Ofcom's assessment of regulatory options is inevitably framed by its incomplete and partial analysis in Section 3, where it proposed to adopt 'Option 2' as the best means of achieving its overall aim of preventing BT distorting competition. Ofcom should therefore revisit its assessment of regulatory options in light of its revised analysis of the risks to SFBB competition during this market review period and the potential impacts in the short and long term.

6.6 Second, Ofcom is insufficiently clear about the key differences between the options it puts forward. In particular, one could ask, what distinguishes Option A from Options B to D? Ofcom does not then fully assess the risks that can arise by moving from a more flexible, effects-based set of remedies and constraints to a 'bright line' approach. This is expanded upon below.

6.7 Third, Ofcom has failed properly to consider the efficacy of the existing set of remedies in place – i.e. the FRAND and EoI SMP conditions, and competition law – in achieving the overall aim of preventing distortive effects. Ofcom should conduct this exercise by reference to behaviours in the market place to date and consider whether any issues relating to the scale of competition in the supply of SFBB services can be attributed to the ineffectiveness of existing legal and regulatory constraints rather than, as BT considers, the strategic choices of different market players to date. Ofcom should also recognise properly the costs of intervention, both to BT and more widely.

6.8 Fourth, building on this last point, Ofcom's assessment of its regulatory options is conducted in a highly generic way with little or no reference to specific issues relating to the provision of SFBB services and to the specific complexities and challenges that arise in relation to SFBB bundles including BT TV and/or BT Sport. As detailed below, in adopting Option B Ofcom is effectively proposing a 'bright line' test that would then be applied across all SFBB bundles. Such a 'one size fits all' approach does not reflect radical differences in the degree of risk on regulatory intervention across different SFBB offers. The specific issues relating to BT TV and BT Sport are covered in Section 7. In assessing its regulatory options around the form of any VULA margin regulation, Ofcom should at least provide the ability to be flexible in its approach across different bundles to reflect those objective differences in risk.

Ofcom incorrectly assesses the adequacy of competition law and dismisses it too lightly

6.9 Ofcom accepts that an anti-competitive margin squeeze carried out by a dominant company would amount to an abuse of a dominant position, contrary to Chapter II of the Competition Act 1998 and/or Article 102 TFEU. At paragraphs 4.40-4.42, therefore, Ofcom (briefly) considers whether competition law would already provide an adequate means of addressing its stated objective.

6.10 Ofcom dismisses the adequacy of competition law, concluding that ex ante regulation is preferable in that:

(a) Competition law would not capture "*all*" the features of a margin assessment "*necessary*" to achieve its aim;

(b) Competition law would not be "*effective*" in achieving its aim; and

(c) Ex ante regulation would minimise risks around BT's non-compliance with ex post competition law arising from uncertainty around the requirement to establish an effect on competition.

6.11 As well as these conclusions being made by reference to Option 2, as discussed above, BT considers that more generally Ofcom's assessment is wholly inadequate and these three findings are unsupported by evidence:

(a) First, even against the terms of its incorrectly formulated objective, Ofcom does not specify in which respects competition law would not capture "*all*" the features necessary to achieve its aim. In fact Ofcom recognises that the *TeliaSonera* judgment[58] notes that adjustments may be made to the dominant

[58] Case C-52/09 *Konkurrensverket v TeliaSonera Sverige AB* [2011] 4 CMLR 982 ("**TeliaSonera**").

undertakings costs in certain circumstances (such as if CPs other than the vertically integrated supplier have costs disadvantages).

(b) Second, it is not at all clear why competition law, which is well understood through its application at UK and EU levels, would be considered ineffective in addressing concerns with price/margin squeeze strategies. For example, Ofcom has investigated and issued a provisional decision in its investigation of BT's SFBB pricing following an original complaint by TTG in March 2013. There was no suggestion that the provisional NGFA decision somehow exposed a deficiency in competition law or left a concern unaddressed.

(c) Thirdly, Ofcom appears to suggest that it is a weakness in ex post competition law that effects need to be considered. It is not clear why Ofcom presents competition law in this way. Ofcom cannot attempt to circumvent an established requirement under existing caselaw, underpinned by sound economic rationale, to conduct an effects analysis by praying in aid the greater certainty provided by ex ante regulation. The reason for requiring an effects analysis in the first place is due to the fact that a margin squeeze cannot be categorised as a per se abuse which can be identified by a crude and limited review of pricing 'on the numbers'. As noted by the General Court in the recent Intel judgment "*the level of a price cannot be regarded as unlawful in itself*"[59]. This is especially the case (as here) where the market to which the margin squeeze allegation relates is complex.

(d) Finally, it appears that when Ofcom was at the stage of rejecting the competition law option, it was not having regard to the provisions of the Costing and Non-discrimination Recommendation which make it clear that any ex ante MST should be concerned with preventing only pricing "*which is not economically replicable* ***which would harm competition***" (emphasis added). The proper comparison should have been between competition law and an ex ante test which allows for an assessment of harm.

Regulatory options considered by Ofcom

6.12 Having erroneously concluded that competition law is inadequate to ensure its objective is met, Ofcom puts forward four options for additional SMP remedies to those already imposed under the FAMR. In summary, the options are as follows:

(a) Option A – an SMP condition requiring BT to supply VULA on fair and reasonable terms, conditions and charges supplemented by guidance;

(b) Option B – an SMP condition requiring BT to set the VULA charge so as to maintain a minimum differential between the wholesale VULA price and the price of the retail packages, supplemented by guidance;

(c) Option C – an SMP condition on BT that requires it to maintain a minimum VULA margin which would be specified by means of a model set out in the SMP condition; and

[59] Case T-286/09, *Intel v Commission*, paragraph 99.

(d) Option D – an SMP condition specifying a minimum VULA margin (expressed as a precise value) that BT must maintain during the review period.

6.13 Ofcom state that Option A would not require the imposition of an additional SMP remedy alongside those imposed by the recently concluded FAMR. Rather, it would use the existing FRAND condition with Ofcom setting out guidance on how this would be applied to address price/margin squeeze concerns. In contrast, Options B to D would involve the imposition of a new additional SMP condition.

6.14 Ofcom states that its assessment of the options is largely based on whether: (i) they will provide sufficient certainty as to the margin BT needs to maintain; and (ii) they are likely to remain appropriate over the period of the review. It states that it will also take account of the regulatory burden on BT (paragraph 4.67).

Ofcom's preference for Option B over Option A is driven by concerns over certainty

6.15 Ofcom dismisses Option A as unlikely to be as effective as Options B-D in that it would provide a lesser degree of certainty about the level of margin BT should maintain. Ofcom was also concerned with the effectiveness and proportionality of Options C and D, in that they could impose a greater or weaker restriction on BT than was necessary or appropriate. Ofcom therefore provisionally concludes that Option B is likely to deliver an appropriate balance between sufficient certainty on the one hand and retaining flexibility on the other.

6.16 While BT agrees with Ofcom's assessment that Options C and D would be unduly burdensome and disproportionate, BT considers that Ofcom's reasons for rejecting Option A and proposing to adopt Option B are inadequate. In dismissing Option A, Ofcom attaches most weight to the lower level of certainty that would be provided under Option A to BT and other CPs about the level of margin BT should maintain compared to all other options.

6.17 Ofcom recognises that Option A would provide BT with a "*reasonable degree*" of certainty (paragraph 4.52) given the stated intention that Ofcom would publish guidance. However, Ofcom then states that guidance would only give an "*<u>indication of the likely approach</u> that Ofcom might take in the future and we may need to revisit our approach each time we make an assessment particularly in relation to a new product not envisaged by the guidance or where market conditions changed during the review period*". (emphasis added)

6.18 Ofcom effectively dismisses as a flaw in Option A something that should instead be recognised as a virtue:

(a) Interpretation of the FRAND condition would need to be by reference to the scope in a particular situation for BT to set upstream and downstream prices in a way that was likely, ultimately, to distort downstream competition.

(b) Guidance on the approach Ofcom would take to FRAND would therefore need to establish that Ofcom would assess compliance by reference not just to BT's costs and revenues, but to underlying market conditions and, ultimately, the likely distortions that could arise as a result of the pricing.

(c) The alternatives to the flexibility provided by issuing non-binding guidance about how any effects-based assessment would be conducted are all 'bright line' tests of the level of BT's margin. Options B to D would be embedded, in varying degrees, within an SMP remedy.

(d) In the context of a complex, dynamic and rapidly changing broadband market in which SFBB services are being provided and the fact that the conditions of supply and demand for SFBB services are very different to the 'plain vanilla' case (see section 2), the more flexible approach to assessing pricing behaviour would be more appropriate.

6.19 BT notes that the only uncertainty provided by adopting such an approach would be in relation to the need to consider likely distortions on a forward-looking basis at the time of the investigation. But the benefits of that flexibility would be a more proportionate approach that would be aimed at only preventing pricing activity that was likely to have an anti-competitive effect.

6.20 As a first step, building on points raised above, Ofcom should analyse whether, and if so how, the flexibility provided by the current regulatory constraints (FRAND and competition law) is failing to ensure BT is not distorting SFBB competition and/or whether, and if so how, certainty is considered to be a material problem.

BT's concerns with Option B

6.21 Ofcom proposes to adopt Option B and sets out details of a 'bright line' approach to assessing BT's margin within an SMP remedy that would apply until the next market review is concluded. The overall impact of this is ultimately dependent on the precise way in which any 'bright line' remedy is formulated. Ofcom goes on to propose that Option B would be implemented by requiring BT to maintain at all times a "*Minimum Margin*" across all "*VULA-based Broadband Packages*" as specifically defined within the SMP remedy.

6.22 While some flexibility of approach would still be provided by the use of non-binding guidance alongside any new SMP condition (to set out how certain costs and revenues would likely be assessed within the test), the proposal is that many critical features of the design of the test would be embedded within the remedy itself. In particular, as proposed:

(a) It would be a static test focussed on prices and costs in a given "*assessment period*" and not on the longer term value operators might consider they would derive when acquiring customers. This would limit BT's commercial options relative to its competitors.

(b) It would require BT to 'pass' the test based on a 60 month customer life that would not change through the market review period and with lower bounds placed on BT's monthly cost of providing bandwidth to support its broadband services.

(c) It would, through the definition of "*VULA-based Broadband Packages*" require the test to be conducted in a rigid way across any and all SFBB bundles, including those with BT Sport and/or BT TV.

(d) It would not provide for any separate consideration of likely distortions in competition. BT would need to maintain the "*Minimum Margin*" as defined at all points in time, unless agreed by Ofcom, and there would be no consideration of effects.

6.23 Ofcom has failed to demonstrate why the constraints imposed by the Option B 'bright line' test are considered proportionate and/or why they are expected to deliver net benefits for consumers over the long run. The risk of Option B – which is not considered at all in Ofcom's analysis of its relative merits compared to Option A – is that it imposes constraints on BT's activity in competition for the provision of SFBB services that do not reflect the commercial realities faced by BT's competitors. As such, BT could be constrained in its ability to compete effectively through pro-competitive actions. In other words, the 'bright line' test gives rise to the risk of Type 1 errors (i.e. false positives) in identifying and prohibiting the behaviour that is not the distortive behaviour Ofcom is actually aiming to address.

Ofcom's approach fails to take utmost account of the Commission's Recommendations

6.24 In reaching its provisional conclusion, Ofcom risks failing to take utmost account of the Commission's Recommendations and the BEREC Common Position. There are a number of references, in particular in the Costing and Non-discrimination Recommendation, which evidence that the Commission considers that NRAs should recognise that (whilst ex post and ex ante margin squeeze obligations fulfil different roles) ex ante margin squeeze obligations still remain concerned with prevention of behaviour that would distort competition so as to cause harm to consumers of the relevant services.

6.25 Specifically, Article 56(c) of the Costing and Non-discrimination Recommendation[60] states that NRAs should make use of their enforcement powers "*Where the NRA considers that a retail offer which is not economically replicable <u>would significantly harm competition</u>*" (emphasis added). This implies that Ofcom should therefore consider, on each occasion that a failure 'on the numbers' occurs, whether that failure would significantly harm competition.

6.26 Therefore, having established as its aim the need to ensure that BT does not use its SMP in the WLA market to distort retail competition in SFBB, Ofcom cannot try to sidestep the requirement to undertake an analysis of whether competition is or would be distorted during the current market review period on the sole basis of concerns with 'certainty'. As set out in Section 4, there is currently no evidence of any distortion in the provision of SFBB, whether actual or prospective. But, given that Ofcom has stated that it needs to be able to monitor at six monthly intervals whether this situation is changing, it is crucial that any test to be imposed by Ofcom is capable of not just measuring costs and revenues, but also of assessing whether prices offered by BT, which may not be considered (on the numbers) economically replicable at that point in time, would significantly harm competition.

6.27 BT also notes that it is not clear from Ofcom's assessment in this Consultation why Ofcom has so fundamentally changed its view since the 2013 FAMR Consultation. The only material developments of which BT is aware are (i) Ofcom's provisional NGFA decision and (ii) the increasing SFBB competition noted in Section 4 above, neither of which should fundamentally have altered Ofcom's provisional conclusions.

[60] See also recitals 62 and 63 of the Costing and Non-discrimination Recommendation.

Indeed, if anything such developments provide further support for a less intrusive SMP remedy.

6.28 In the 2013 Consultation, Ofcom noted that any of its chosen options would "*involve a trade off between (possible) greater speed [of an investigation] and certainty versus a greater risk of regulatory failure*". Ofcom also noted that its preferred option at the time to rely on the existing FRAND condition supplemented by guidance would provide "*greater flexibility to take into account changes in the provision of superfast broadband that occur during the period covered by this market review*" (paragraph 11.400). It would also reflect the fact that BT's competitors include "*large, well resourced*" companies such as TTG, EE and Sky (paragraph 11.401).

6.29 Ofcom has not provided analysis that suggests that there has been any material change in the conditions of the market since the 2013 Consultation. As a result, Ofcom has not identified any trigger for an increase in regulation as compared to its existing package of measures. Given the onus of Ofcom (as set out in Annex B) to choose the least intrusive measure that would achieve its aim, it must be able to justify why the measures that were previously considered sufficient are no longer acceptable.

6.30 Overall, for the reasons set out above, it is clear that Ofcom's choice of Option B cannot stand.

Assessment of compliance / testing options

6.31 Based on feedback from a confidential respondent, TTG and Vodafone, Ofcom has developed three options for compliance monitoring and testing:

(a) Option (i) – BT to provide the data necessary to monitor compliance with the proposed VULA margin condition to Ofcom every six months, with Ofcom conducting a high level assessment of the margin at six monthly intervals.

(b) Option (ii) – BT to provide the data necessary to monitor compliance with the proposed VULA margin condition to Ofcom before it launches a new or revised product as well as every six months, with Ofcom conducting a high level assessment of the margin before and after product launch.

(c) Option (iii) – Ofcom to approve new or revised products prior to launch having assessed whether or not they comply with the proposed VULA margin condition.

6.32 Ofcom conducts its assessment of the various options by reference to a number of criteria, including (i) the extent to which each option is able to assist with identifying any breaches in a reasonable timeframe; (ii) whether compliance monitoring is likely to enable an accurate assessment; (iii) the level of transparency; and (iv) the regulatory burden.

6.33 Having conducted its assessment, Ofcom concludes that Option (i) is the most proportionate option by providing Ofcom with the ability to assess BT's compliance on a frequent basis and intervene in a reasonable timeframe. Ofcom concludes that the benefit of the additional requirement in Option (ii) to provide data prior to the launch of new products would not be sufficiently greater than Option (i) to justify this additional requirement.

6.34 The specific detail of issues raised by the provision of data to monitor compliance are clearly secondary to the issues BT raises in this response proposing changes to Ofcom's overall approach. However, and without prejudice to BT's primary submissions elsewhere in this response (see in particular Sections 5 and 7), BT agrees with Ofcom's specific assessment of options around compliance monitoring and in particular its dismissal of Options (ii) and (iii). BT proposes that Ofcom revisits the detail of these issues to fit with the final remedies adopted once this review has been completed.

Conclusions

6.35 For the reasons set out above, BT considers that Ofcom's decision to reject reliance on competition law (wholly or partially) and its choice of Option B over Option A is flawed. Ofcom appears to consider that certainty should trump flexibility in what is a complex area. It has not clearly rationalised this trade-off.

6.36 In terms of Ofcom's overall approach to the Consultation, BT is also concerned that some of Ofcom's rationale in Section 4 suggests that any remedy that requires a separate assessment of the likely effects of pricing is inferior to remedies that avoid this. As set out in the next section of this Response, an effects analysis becomes ever more critical if one moves from testing the margin on relatively homogeneous propositions built on provision of upstream inputs from BT to looking at the issues raised by BT's provision SFBB bundles including BT Sport and/or BT TV.

7. The Scope of the Proposed Ofcom Test and Treatment of SFBB Bundles Including BT Sport and BT TV

Introduction and summary

7.1 As noted in Section 6 above, Ofcom's assessment of its regulatory options in the Consultation fails to consider the real trade-off that is implicit in its choice of Option B over Option A: i.e. Ofcom proposes a 'bright line' test within an SMP remedy that prioritises certainty over flexibility without considering the net impacts on BT's ability to compete fairly in providing SFBB services in a range of bundles. Ofcom therefore fails to consider the impacts Option B could have on the effectiveness of competition across markets and, over the long run, on consumers.

7.2 The scale of this impact will be driven by the detail of Ofcom's proposed design of the remedy under Option B. This Section considers the fundamental issue of the scope of SFBB offers covered by the remedy and, specifically, whether all SFBB bundles – including those with BT TV and/or BT Sport – should be considered. In Section 6 we consider further issues regarding the conceptual design of the proposed imputation test and the specific proposals for populating the proposed test with cost and revenue data.

7.3 Ofcom proposes to apply the test across the full range of BT's SFBB offerings – i.e. dual play bundles <u>and</u> SFBB bundles including BT TV and/or BT Sport. In so doing, Ofcom proposes effectively to treat the costs of BT TV and BT Sport as if they were simply an expense of providing SFBB and then establish the SMP remedy such that the margin BT must earn across the range of SFBB bundles is sufficient to cover these and all other costs of supplying the bundles.

7.4 However, in doing so Ofcom crucially fails to recognise the following:

(a) In providing SFBB bundles including BT TV and/or BT Sport, BT is not only competing in the broadband market; it is also competing across a range of pay TV and content markets against suppliers who offer both stand-alone TV services and triple-play services. As set out in Section 4, BT faces a number of challenges competing against a dominant player (Sky) and other players with a wider range of wholesale content deals to differentiate their offers from those supplied by BT.

(b) Any losses incurred by BT in its provision of BT TV and BT Sport do not result from a strategy to foreclose competition in the retail broadband market and, in particular, SFBB. In relation to BT Sport, BT's current losses are in fact simply a reflection of the realities facing a new entrant into pay TV markets which themselves require effective regulatory intervention to address Sky's position. BT's monetisation strategy following the 2012 FAPL auction was the best, loss-minimising option available to it at the time. Ofcom should recognise the realities facing BT before seeking to exacerbate the difficulties its faces as a new entrant in the broadcast of channels.

(c) Therefore, the costs BT incurs in providing BT TV and BT Sport are intended to be long term strategic investments to improve our retail capabilities and not simply an 'expense' of providing SFBB. By treating them as such within the proposed 'bright line' MST, Ofcom is proposing to constrain the way BT recovers these investment costs. This risks undermining BT's ability to compete effectively in pay TV markets and in the acquisition of content rights. At the same time, Ofcom has failed to establish that the proposed constraints are a proportionate response to addressing any appropriately identified competition issues in the provision of SFBB services.

7.5 BT submits that it is imperative that these issues are properly factored into Ofcom's assessment of its regulatory options. This Section – which should be read in conjunction with the assessment of Ofcom's treatment of BT Sport by Compass Lexecon at Annex C – sets out BT's assessment of the options before Ofcom, reflecting the overall market context described at Section 4 and the commercial realities driving BT's investments in BT TV and BT Sport. In particular, BT addresses the following issues:

(a) The risks of including SFBB bundles with BT TV and BT Sport bundles within a 'bright line' test;

(b) A 'bright line' test covering bundles with BT TV and/or BT Sport would undermine BT's commercial objectives in investing in these capabilities;

(c) Ofcom's proposed approach to assessing the unit costs of BT TV and BT Sport compounds the general concerns about the 'bright line' test;

(d) The wider risks and impacts of Ofcom's approach;

(e) Ofcom has failed to take utmost account of the dangers of a single measure test in an ex ante margin squeeze obligation; and

(f) For completeness, BT's critique of Ofcom's rationale for including SFBB triple-play bundles within the proposed VULA margin SMP remedy.

7.6 In summary, BT proposes that, while Option A would generally represent a proportionate and effective remedy to address potential competition concerns for the reasons set out in Section 6, it might be possible to make a case for an ex ante MST on the basis of Option B – provided that it is appropriately formulated – in a more focussed way <u>targeted at dual-play SFBB offers without BT Sport only</u>. This approach would provide a high degree of certainty and, therefore, comfort to Ofcom regarding the pro-competitive terms on which VULA is being supplied, whilst ensuring that inappropriate 'bright line' constraints on BT's provision of BT TV and/or BT Sport in SFBB bundles are avoided.

The risks of including SFBB bundles with BT TV and BT Sport bundles within a 'bright line' test

7.7 Section 2 established the conditions present in the 'plain vanilla' case of margin squeeze, where a finding of profit sacrifice under an imputation test (as set out by Ofcom in Figure 5.1) is likely to give rise to exclusionary effects and distortion of competition in the downstream market.

7.8 The key conditions present in the 'plain vanilla' case are:

(a) One key input, supplied by one dominant upstream supplier;

(b) Downstream firms – including the dominant upstream company – competing in the supply of homogenous products;

(c) Rival downstream firms not having significant advantages relative to the downstream division of the dominant company; and

(d) Historically known, or combination of historically known and reasonably predictable, costs and revenues.

7.9 As set out at paragraph 4, SFBB services are supplied in a diverse range of offers into the competitive retail broadband market with different suppliers pursuing different strategies to target different segments of customers. As such, the provision of SFBB services cannot be said to fit neatly into the framework established by the vanilla case.

7.10 In these circumstances, any 'bright line' imputation test of profit sacrifice will not provide a strong indicator of exclusionary effects and distortion. Any such test is likely to present risks of 'Type 1' errors by constraining BT from pricing to levels that may be unlikely to distort competition. As set out in Section 6, these risks could be avoided, or at least minimised, by adopting the more flexible approach set out under Option A, rather than the 'bright line' test proposed under Option B. In particular, the use of FRAND with guidance would allow specific consideration of likely distortive effects on a case-by-case basis.

7.11 BT's position is that the risks of 'Type 1' errors are most acute in relation to the provision of SFBB services in bundles with BT TV and/or BT Sport. In particular, Ofcom fails to recognise the following:

(a) While the provision of SFBB dual-play services may not be based on a <u>single</u> input, it is largely based on the provision of Openreach's portfolio of regulated inputs (i.e. LLU/WLR and GEA). In contrast, the provision of SFBB bundles with pay TV services also requires access to platform capabilities, content rights and/or wholesale access to channels. As noted above, this requires access to inputs from another dominant vertically integrated firm, given Sky's position in the provision of certain essential channels. BT has been unable to gain such access, whereas its competitors have.

(b) While different operators may target different customer segments, they will tend to offer a broadly similar portfolio of SFBB (and SBB) dual play services based on Openreach's upstream inputs. Provision of SFBB services with pay TV services is much more heterogeneous, reflecting the functional capabilities of different platforms and the commercial arrangements in place to enable supply of particular basic and premium content.

(c) While rival downstream companies may have relative strengths in providing dual play services, these will tend to arise because of their chosen market strategies – e.g. to target lower value segments at lower cost. Differences in their strengths in the provision of triple-play SFBB services which include pay TV services will be more marked, particularly in the case of Sky given its position in relation to control of critical basic and premium content, as well as its (currently) limited obligations to wholesale that content to BT. Other providers will also have advantages over BT due to their wholesale arrangements.

(d) The revenues and costs of SFBB dual play services will at least be known on the basis of historic data, even if predictions will still carry some uncertainty given, for example, future changes in costs, use of bandwidth and technological changes impacting unit costs. In contrast, BT's costs of supplying BT Sport in particular will be less predictable given uncertainties over the range of content that will be provided over time and the terms of access to that content (in particular rights costs for premium sport). BT's unit costs will also be driven by growth of the base taking BT TV and BT Sport.

7.12 BT commissioned Compass Lexecon to consider the economic rationality of Ofcom's specific proposal to include the costs of providing BT Sport in SFBB bundles within the proposed 'bright line' test. Among other things, the report from Compass Lexecon enclosed at Annex C reiterates the need for any assessment of price/margin squeeze to consider both profit sacrifice and exclusion. It also exposes the limitations of any 'bright line' test of profit sacrifice in identifying pricing likely to distort competition. In the particular context of the provision of BT Sport within SFBB bundles, the Compass Lexecon report identifies three key issues:

(a) The competitive effect of BT Sport on the provision of SFBB will depend on the value SFBB customers place on the channels provided;

(b) Different customers will attach different valuations to the BT Sport channels and evidence suggests that [ ]% of BT broadband customers attach CONFIDENTIAL
little or no value to those channels; and

(c) Hence, the total cost of providing the BT Sport channels at this time is likely to exceed the total value placed on it by customers.

7.13 Compass Lexecon conclude that (i) exclusion or marginalisation could only arise as a result of the offer of BT Sport for free if other SFBB providers had to compete for customers who attach at least some value to BT Sport channels in order to reach minimum efficient scale; and (ii) any test aimed at preventing exclusion would only need to provide margin to BT's competitors equal to the value placed on BT Sport by the marginal customer required to reach minimum efficient scale.

7.14 The Report demonstrates that basing a 'bright line' test solely on profit sacrifice/cost recovery would result in BT setting prices that offered excess margin to its competitors – i.e. margin not required to compete effectively for a sufficient set of SFBB customers given their valuation of BT Sport.

7.15 The Compass Lexecon report therefore confirms the risk that a 'bright line' test of profit sacrifice applied to BT Sport would prevent BT from pricing in ways that would not distort competition in the provision of SFBB services.

A 'bright line' test covering bundles with BT TV and/or BT Sport would undermine BT's commercial objectives in investing in these capabilities

7.16 Ofcom's proposed new SMP condition would establish a static test to consider the level of BT's margin. The test would:

(a) Identify effective monthly prices applied to the cohort of newly acquired SFBB customers in a specific assessment period;

(b) Identify the monthly unit costs of supply during that assessment period;

(c) Identify the unit cost of acquiring that cohort of customers in that period; and

(d) Consider whether the monthly unit margin earned in the assessment period would be sufficient, when discounted, to recover the unit acquisition costs within an assumed ACL of 5 years[61].

7.17 The test therefore effectively treats the monthly margin BT makes during the assessment period as fixed across the customer life.

7.18 By including SFBB bundles with BT TV and/or BT Sport within the scope of the 'bright line' test, Ofcom has set itself the problem of how it should treat the monthly unit costs of supplying BT TV and BT Sport. As detailed further below, this compounds the static approach. Among other things, this totally fails to reflect the intended long-term strategic basis on which BT has and will be investing in these capabilities.

7.19 Section 5 of the Consultation identifies the growing significance of broadband triple-play bundles in the current broadband market. Ofcom also notes the size and growth of these bundles over time and concludes that "*excluding triple-play fibre packages would exclude an important, and growing, set of products from the assessment*" (paragraph 5.85). Similarly in relation to BT Sport, Ofcom notes that its launch makes "*additional TV channels available to BT's triple-play customers and also makes BT's dual-play [SFBB] more attractive*" (paragraph 5.86). The MST therefore captures both BT TV and BT Sport.

7.20 Crucially, however, Ofcom's simplistic analysis fails to reflect the true nature of competition for triple-play bundles. However, as noted by Andrea Coscelli in a paper presented in 2008, when assessing bundles, "*<u>Actual competition in the downstream markets is key</u> to choosing the approach to take*" (emphasis added).[62]

7.21 Sky and Virgin in particular have been able to construct compelling triple-play propositions for those customers who value their pay TV offerings and each of BT's principal competitors have distinct advantages over BT. For example:

(a) As noted in Section 4, Sky is the dominant player across the entire pay TV value chain, which, due to its control of critical content rights and ownership of "*must have*" channels, is able to control wholesale access and terms of supply to its downstream retail competitors, thereby limiting the ability of those third parties to compete in (profitably) acquiring pay TV subscribers;

(b) Virgin is a long term pay TV provider, with almost the full range of content (albeit on disadvantageous terms pursuant to Sky's rate card pricing);

(c) TTG (which also has access to the full range of Sky's content) is pursuing an entry strategy based on supplying set-top boxes at an upfront loss, which has to date been more effective than BT at generating customer numbers.

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[61] See Section 8 for BT's comments on the proposed use of a 5 year ACL in the design of the 'bright line' test

[62] *Margin squeeze and predatory prices by multiproduct firms*, The Hague, 3 April 2008.

7.22 BT has attempted to respond to this competitive landscape by investing in its own pay TV platform and services over recent years. However, crucially, BT's ability to construct a compelling offering has been significantly hampered by the structural problems around access to key channels and rights in pay TV given Sky's dominant position across relevant wholesale markets. While Ofcom may consider resolution of these issues outside the scope of the FAMR (paragraph 5.85), this context should not be ignored when considering issues of profit sacrifice in relation to the ongoing provision of the broader set of SFBB bundles including BT TV. Indeed (on the assumption that the underlying competition problems with access to pay TV content are resolved by Ofcom) BT continues to make significant investments – e.g. in developing and launching its YouView TV and multicast capabilities – with a view to building a profitable pay TV business and attempting to compete for triple-play customers.

7.23 Furthermore, the significant levels of investment needed to acquire rights to even launch a sports channel in the first place mean that no entrant would expect to recover incurred costs immediately. BT's strategy in the provision of the BT Sport channels will evolve over time reflecting the size of the base and the identification of the valuations placed on the services offered by customers and therefore their willingness to pay. In this context, Ofcom should recognise:

(a) Any losses that BT will make in relation to BT Sport during the current market review period have been driven by BT's attempt to break into a new market, not by BT's attempts to compete in the provision of SFBB;

(b) BT is motivated to extract the maximum value from its content at all times. BT's strategy in relation to the 'stand-alone' pricing of the BT Sport channels to its residential, commercial and wholesale customers, and the provision of BT Sport within SFBB (as well as SBB) bundles at zero additional charge, is set to maximise value and minimise short term losses;

(c) In respect of the terms of supply of BT Sport within SFBB bundles, BT's judgment to date has been that value can be best derived through offering the channels for zero incremental cost – i.e. increased customer acquisitions and extended ACL – and that this value is higher than the value of alternative strategies.

7.24 In these circumstances, it is not appropriate simply to derive a recurring 'cost' of making the channels available to SFBB customers that is calculated from the overall short term losses that BT is currently making on the provision of the channels. These losses are more appropriately viewed in the context of BT's provision of a sports channel, and not SFBB bundles. The specific 'cost' of making BT Sport available to SFBB customers is more appropriately treated as being offset by the incremental value BT is expected to derive over time from building a viable pay TV business (again, on the assumption that the underlying competition problems with access to pay TV content are resolved by Ofcom).

7.25 For both BT TV and BT Sport, therefore, BT has made and is making what are intended to be longer term strategic investments in its (at present, limited) capabilities to compete in a risky and challenging area, in particular given existing regulatory asymmetries and Sky's behaviour. Constraining BT even further, by requiring it to take a short term and static view of recovery of investment costs, would exacerbate the disadvantage which BT faces. It would also provide a flawed basis on which to even consider the question of whether a "*slightly higher cost*" operator could profitably match BT's SFBB prices.

7.26 As part of the Consultation, Ofcom seeks in effect to avoid the fundamental issues that persist with respect to Sky's dominance by stating that it will address these "*through separate regulatory action*" (paragraph 5.87), which would be both uncertain in scope and very lengthy in duration. The impact of Ofcom ducking this key issue is to reduce its proposed MST to a pure numbers based exercise. BT submits that such an uncoordinated approach to what (on Ofcom's own analysis) are linked issues is not an appropriate way to manage the regulatory process. By proposing an MST that applies to BT's triple-play bundles including BT Sport, Ofcom is exacerbating the lack of level playing field, and, by adopting an adjusted EEO-based test, is in fact tilting that playing field further in Sky's direction, to the detriment of BT. If it were to be imposed in its current form, Ofcom's proposed VULA margin regulation – designed ostensibly to address market power in the upstream broadband input – would bite disproportionately on BT, thereby further hobbling BT in its (already limited) attempts to compete against Sky and other CPs, and actually creating a further distortion in the related markets. In evaluating the costs and benefits of the various possible options for achieving Ofcom's objectives, Ofcom must weigh up <u>all</u> costs, including those that extend beyond the broadband market. It has singularly failed to do so.

7.27 BT does not propose that Ofcom should neglect to deal with any purported concerns in the broadband market due to the issues BT has faced with respect to Sky's dominance in separate markets. However it is incumbent on Ofcom, to the extent these areas present linked issues, to address them holistically where possible and take them into account in a detailed impact assessment. Crucially, Ofcom should not, through the implementation of the MST, impose severe regulatory constraints on BT in order to prevent a small and uncertain risk of adverse effects in relation to broadband competition. The MST itself causes significant adverse effects by preventing BT from competing in pay TV, while leaving Sky's market power largely untrammelled.

Ofcom's proposed approach to assessing the unit costs of BT TV and BT Sport compounds the general concerns about the 'bright line' test

<u>*Ofcom's proposed approach to calculating the unit costs of BT Sport*</u>

7.28 Ofcom proposes to identify the net cost of BT Sport by reference to:

(a) The total cost of providing the channel <u>during the assessment period</u>, which would itself be based on spreading relevant rights costs (i.e. for rights made available during the particular assessment period) evenly per month across the duration of the rights period;

(b) All direct channel revenues <u>during the assessment period</u>; and

(c) The size of the broadband base <u>during the assessment period</u>.

7.29 The sports rights costs are by far the most significant element of the costs of providing the BT Sport channels (about two thirds of total costs). The treatment of such costs in any consideration of profit sacrifice is therefore crucial. But here, again, Ofcom proposes an inappropriately rigid approach:

(a) First, Ofcom would evenly spread rights costs across each month of a rights period and then net off direct revenues earned during a specific assessment period to establish, effectively, the 'required margin' to be earned on SFBB bundles. Ofcom would therefore appear to be implying that BT should recover sports rights costs evenly each assessment period (or, at least, if it did not, that concerns with the overall level of margin earned across SFBB bundles would arise). This is unrealistic for the following reasons:

  (i) BT Sport is in its start-up phase and will face challenges in recovering costs in such an even way as the base of customers is being built.

  (ii) The number of months actually covered by sports seasons and when the content will actually be broadcast will differ, as will impact monthly revenues during close seasons.

  (iii) The relative attractiveness of specific rights at particular periods within those seasons may vary.

  (iv) At the start of a rights period for new content, Ofcom's proposals imply that rights costs would come into the calculation on a flat monthly basis immediately (i.e. from the month they became 'live') while the timing of any additional revenues will be driven by the specific value attached to those rights which may increase during the relevant sports season (e.g. later rounds of cup competitions to give a general example).

  Requiring the level of margin across the SFBB portfolio to vary from assessment period to assessment period to reflect any unevenness in revenues during each month of a continuous rights period would fail to capture the level of recovery that may actually be achieved over the entire rights period. Ofcom's proposals could therefore penalise BT's overall SFBB pricing strategies even where BT was pursuing commercially rational strategies to extract maximum value during a rights period in non-uniform ways.

(b) Second, Ofcom's proposed modelling approach takes the net cost per subscriber calculation for a given assessment period and assumes this applies for each year of the acquired customers average life. This would therefore give a completely misleading view on profit sacrifice in relation to BT Sport:

  (i) Ofcom implicitly assumes that the monthly rights costs at the point of acquisition remain constant through the customer life, even though the rights available in assessment periods during this three year market review phase – such as the current set of FAPL rights – will expire before the end of any acquired customers' assumed five year customer life[63].

(ii) Ofcom implicitly assumes that the monthly direct revenues at the point of acquisition remain constant through the customer life – i.e. there is no change on the terms on which BT is providing stand-alone subscribers, commercial customers and SFBB customers with access to the BT Sports channels and in the volume of customers paying for the channel.

Both assumptions are completely unrealistic. The cost and/or customer willingness to pay for any acquired rights will be likely to change after each auction. For instance, after the next FAPL auction, BT could have the same/similar rights packs at a lower cost, more/higher value packs at same or higher cost or even no packs at zero cost. Ofcom's proposed 'bright line' test would implicitly assume that BT would retain the same packs at the same price and extract the same value in the market such that net cost stayed constant. But this scenario is clearly unrealistic and wholly inconsistent as BT would not continue to invest the same amounts in the same content if there were no expected increase in net value generated as a result.

Ofcom's proposed approach to calculating unit costs of BT TV

7.30 Due to BT Sport being in its start-up phase it will be unavoidable to rely, to some degree, on forecast data as opposed to audited management account data. This is because prices, customer volumes and costs will continue to evolve before reaching a sufficiently stable state that would allow the use of historical data to assess the most recent performance of BT Sport. However, using different data sources carries the inherent risk of double counting some common costs that also appear in the historical management accounts used for other parts of the VULA margin test. In the context of Ofcom's provisional NGFA decision, Ofcom noted a double counting of SG&A costs in the net costs of BT Sport but did not correct for the double count in all years. This would therefore need to be given explicit consideration in any assessment of profit sacrifice in relation to BT Sport.

7.31 Any analysis of the possible future of BT Sport would quickly establish that it is characterised by significant uncertainty. This arises from the significant barriers to entry in the wholesale provision of premium sports channels, due to the difficulties in acquiring rights at the upstream level created by Sky's dominance in this sector. In particular, the real cost of entry into supplying premium sports channels is not the one-off cost identified by Ofcom in setting up the structures needed to launch the channel, but much more significantly the investment in premium sport rights whose costs are kept artificially high by Sky's dominant presence in this market, following years of high and persistent super normal profits.

7.32 Ofcom's proposed treatment of the unit costs of supplying BT TV would also take a highly static short term view. While TV is not a new service for BT, [CONFIDENTIAL

[63] In fact, if Ofcom were to introduce the proposed 'bright line' test in November 2014, then SFBB customers acquired in that month would only have access to these specific FAPL rights for 18 months (until May 2016) of their assumed 5 year life.

], which has resulted in the need to make ongoing investments to improve our platform capabilities – e.g. investing in and rolling out YouView boxes to customers and investing in multi-cast capabilities. BT's objective is to make TV a profitable part of its business but a static view of costs and revenues during a particular assessment period in this market review will not indicate anything about expectations of profitability of BT TV across a customer life.

7.33 In this regard, BT notes that at Annex II of the Costing and Non-discrimination Recommendation, the Commission recommends that, "*NRAs should evaluate the profitability of the flagship products on the basis of a* <u>*dynamic multi-period analysis*</u>."[64] (emphasis added)

7.34 In contrast, Ofcom's proposed approach to assessing the costs and revenues of BT TV would fail to take into account the fact that:

(a) Revenues may increase over the life time of the customer as opportunities to extract value via the TV service increase with access to content – an issue that will depend on effective regulatory action to address existing structural concerns. Ofcom's static view embeds all the structural problems currently faced and leaves BT facing additional constraints on its market activity as a result of regulatory failings elsewhere.

(b) Successful growth of the business will lead to lower unit costs in key areas.

(c) Success of the business should ultimately help extend customer life for customers taking triple-play bundles.

<u>*Concluding comments on Ofcom's proposed approach to calculating unit costs*</u>

7.35 BT Sport is clearly at a very early stage of its start-up and growth phase. It has been launched as recently as August 2013, so at the time of writing it has been in existence for just over one year. BT TV has also face ongoing challenges requiring further investments to move the business forward. Given BT's longer term strategic plans, BT can be expected, particularly under Ofcom's proposed approach to identifying unit costs, to make losses on BT Sport in the assessment periods covered by this market review period albeit at a falling level as it moves to longer term profitability.

7.36 By taking an entirely static view of the costs of these services in SFBB bundles based on Ofcom's assessment of unit costs at the time customers are acquired, Ofcom will inevitably overstate the costs and extent of any profit sacrifice. Commercial logic would dictate that BT Sport and BT TV would continue to exist in the longer term <u>only</u> if performance could be expected to improve over time. [CONFIDENTIAL

] Ofcom's assumption of an unchanged cost and revenue profile over an entire customer lifetime is therefore a contradiction in itself and exposes the need for

[64] Annex II, paragraph (v).

Ofcom to reverse its proposal to consider these costs within its proposed 'bright line' test.

7.37 Most importantly, the proposed treatment of the costs and revenues of BT Sport and BT TV – and the impact of any identified losses – would impose a very significant burden on BT by requiring such losses to be covered through the overall margins across SFBB services in an assessment period. The fact that Ofcom is proposing this approach, without having at this stage undertaken proper consideration of the effect of its proposals on BT's investments in BT TV and BT Sport, is a procedural flaw that renders its conclusions in this regard unsustainable. Ofcom must give itself the opportunity to consider all relevant factors relating to costs and cost recovery as well as specific issues relating to the likelihood of distortive effects before placing specific constraints on BT's pricing strategies.

The wider risks and impacts of Ofcom's approach

7.38 As noted in paragraphs 7.21-7.26 above, BT already faces serious constraints in attempting to compete in pay TV markets, given, in particular, Sky's dominance and existing regulatory asymmetries. Absent such constraints being addressed by effective Ofcom regulatory action, it is clear that BT would need either to make major changes to its sport business or to exit the market. Crucially, Ofcom's proposed MST risks further exacerbating this position to the further detriment of consumers.

7.39 Ofcom's proposals also grant competitors additional margin to compete against BT for SFBB over and above what is necessary for effective competition for those services. As set out in the report by Compass Lexecon, this would create an artificial regulatory pricing 'umbrella', under which BT's competitors could seek shelter, therefore resulting in a negative impact on consumers through inefficient pricing over and above the competitive level. Hobbling BT in the manner proposed through the imposition of the MST will not only provide unwarranted assistance to BT's competitors, it will also harm BT's ability to compete in pay TV markets. As the UK regulator of the communications industry as a whole, Ofcom has an obligation to adopt a much more nuanced and cautious approach, rather than the blunt tool presented by the MST.

BEREC's predecessor, the ERG, has recognised the dangers of a single measure test in an ex ante margin squeeze obligation – but Ofcom has not taken account of this

7.40 The ERG report of the *Discussion on the application of margin squeeze test to bundles*, referred to in the BEREC Common Position at BP 49b, makes clear the following:

> "*…on some occasions, the test outcome in isolation may result in an incorrect appreciation of the possibility that a specific offer or group of offers can foreclose the market to competitors… [I]n the case of bundles, the difficulties pointed out in the design of tests means that their sole use as determinants of a MS taking place may not always be suitable. In such circumstances, one may*

wish to consider other indicators in assessing the likelihood that a MS occurs as a result of the marketing of a specific bundle that has failed the test."[65]

7.41 The above extract highlights very clearly the fact that 'bright line' tests – such as the MST proposed by Ofcom – may result in an incorrect appreciation of whether pricing assessed pursuant to the test will actually lead to harm on the relevant market. The conclusion is that NRAs "*may wish to consider other indicators in assessing the likelihood that a [margin squeeze] occurs as a result of the marketing of a specific bundle that has failed the test*."

7.42 This advice makes it clear to NRAs that they should exercise a high degree of caution when tests involve bundled offerings in order to avoid getting the wrong result. However, there is no indication in the Consultation that Ofcom has exercised such caution. Indeed, Ofcom appears not to have considered this possibility, having merely adopted the conclusion that a margin test would be required, and then subsequently gone on to include in that test BT TV and BT Sport, when they are clearly not parts of the bundle which are based on VULA. BT considers that Ofcom should have greater regard to the BEREC position.

A proposed way forward: limit the 'bright line' test to SFBB dual play offers with BT Sport only

7.43 BT's position remains that, even for dual play services only, an additional SMP remedy imposing a 'bright line' test is not necessary given the constraints presented by competition law and the existing FRAND SMP remedy. BT's position is all the more forceful in relation to BT Sport and BT TV, given the flaws described above that arise in attempting to establish a 'bright line' test to cover the provision of BT Sport within SFBB bundles.

7.44 However, to the extent that an MST can be appropriately designed, formulated and applied in a flexible way that can reflect relevant market changes during this market review period (see Section 8), BT considers that Ofcom should instead <u>limit such a test to SFBB dual play services (without BT Sport) only</u>. As the risks of this more limited test giving rise to Type 1 errors can be more readily minimised, it could, on balance, provide the benefits Ofcom and CPs are seeking in terms of certainty without unduly constraining BT's ability to compete fairly.

7.45 BT notes Ofcom's position that applying a 'bright line' test to only a subset of BT's SFBB services may result in BT being able to "*circumvent*" Ofcom's regulatory aims (paragraph 5.76). However, limiting to the 'bright line' test in this way would actually provide a high degree of comfort that BT was not distorting competition by:

(a) explicitly demonstrating that operators would be able to provide SFBB services and compete effectively for a significant share of customers; and

(b) providing a clear start point for assessing the more complex set of competition issues that would need to be considered in relation to the effects of BT's provision of SFBB bundles with BT TV and/or BT Sport.

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[65] Paragraphs 111 and 113 of the ERG report of the Discussion on the application of margin squeeze test to bundles, ERG (09) 07, March 2009.

7.46 While BT recognises that the provision of broadband services, including SFBB services, in triple-play bundles is a growing, a considerable proportion of the broadband market still purchases broadband in dual-play bundles. Moreover, while BT offers BT Sport at zero additional charge to its broadband customers, [ ]. Furthermore, while the provision of triple-play bundles with pay TV is growing, around 80% of BT's broadband customers still do not currently purchase broadband in such bundles. CONFIDENTIAL

7.47 In such circumstances, were BT to 'pass' an appropriately formulated MST on dual play bundles only, this should provide comfort to Ofcom that operators could purchase VULA inputs and compete effectively in the provision of SFBB dual play bundles for a substantial segment of the broadband market – i.e. those who do have low or no value of BT Sport and/or who are not purchasing SFBB in triple-play bundles. The enclosed report by Compass Lexecon sets out that such an MST would allow BT's competitors to achieve minimum efficient scale and would therefore remain active in the market.

7.48 Furthermore, such a 'bright line' test would provide a relevant starting point for considering whether any broader set of competition concerns could be likely to emerge as a direct result of the terms on which BT provided the other SFBB bundles. It would also demonstrate how such concerns could be best addressed and considered given the high risk of 'Type 1' errors arising:

(a) First, if the 'bright line' dual play test is passed, then mathematically any broader concerns with profit sacrifice across all BT SFBB bundles could only be failed if the additional services in those broader bundles – i.e. BT TV and/or BT Sport – were provided at incremental prices within the bundle which were considered to be beneath the additional costs of supplying those services in SFBB bundles. As set out in this Response (see paragraphs 7.21-7.26 above), Ofcom's proposed approach to the treatment of BT TV and BT Sport costs within the proposed broad 'bright line' test is highly static, short term and would be inconsistent with the basis on which BT has made and is making investments in these areas. It would, therefore, be far more appropriate to assess issues of cost recovery on a forward-looking basis in a more flexible legal and regulatory framework, rather than within a 'bright line' test. This would, in particular, allow for a full assessment of BT's commercial and strategic drivers.

(b) Second, even if profit sacrifice were identified in relation to a broader set of SFBB bundles, then the fact that the 'bright line' test on dual play was passed would mean that:

(i) any potential impact on dual play providers from BT's provision of BT Sport at zero additional charge would be restricted to those customers who attach some positive value to the content BT is offering.

(ii) any potential impacts on competition in the supply of SFBB triple-play bundles would also be restricted given that:

(A) a provider already supplying a customer with a profitable Pay TV service without broadband, such as Sky, will be able to upsell a SFBB triple-play bundle to that customer at an incremental profit. This is because they will be able to profitably match the terms of BT's provision of the 'additional' SFBB dual play service unless (a) the customer attaches a high value to the BT Sport channels offered at zero incremental cost; and/or (b) the customer views the value of the BT TV offering as sufficiently attractive against the value of the Sky TV offering such that they would switch to purchasing the triple-play provision by BT.

(B) The ability of an existing provider of profitable dual play bundles to offer profitable and compelling triple-play bundles is likely to be more dependent on the terms on which they can access the additional pay TV/content inputs and compete against Sky and Virgin, than on the terms on which BT supplies BT Sport and/or BT TV in bundled services to its customers.

7.49 The Compass Lexecon report enclosed at Annex C considers these matters in more detail in relation to the specific issue of BT Sport. That report emphasises that the focus of any concern about exclusion or distortion should be on the value attached by individual customers to the BT Sport channels rather than the cost faced by BT.

7.50 Ofcom has given no consideration to the issue of value and should acknowledge that, absent such an assessment, no distortive effects could be assumed in relation to the terms on which BT provides BT Sport.

7.51 For these reasons, as well as the specific concerns with the way Ofcom proposes actually to assess profit sacrifice, BT does not consider that Ofcom can simply state (without more) that BT could use its provision of BT TV and/or BT Sport to circumvent the aims of the proposed SMP remedy. It has, therefore, no evidence-based rationale for imposing a 'bright line' test of economic replicability which does not take into account whether any failure on the numbers will cause any material harm to consumers.

BT's critique of Ofcom's rationale for including SFBB triple-play bundles within the proposed VULA margin SMP remedy

7.52 For completeness, BT has also assessed the specific points raised by Ofcom in Section 5 (paragraphs 5.78 to 5.88) of the Consultation in justifying its proposal to include SFBB bundles with BT TV and/or BT Sport within the scope of the proposed 'bright line' test.

7.53 Ofcom's main arguments are:

(a) The provision of SFBB triple-play bundles may not solely depend on BT's provision of VULA, but is nevertheless wholly reliant on it, in that without VULA, TTG and Sky would not be able to offer such triple-play bundles.

(b) Exclusion of triple-play propositions from the margin assessment could lead to BT "*being able to circumvent the aims of [the] proposed SMP condition" and other operators "would effectively be excluded from the triple-play segment*."

(c) There is no need to conduct a retail level analysis of competitive conditions in relation to triple-play packages or conclude on retail market definition as an inability to compete for SFBB customers seeking dual-play <u>or</u> triple-play bundles would affect general competition for SFBB customers.

(d) The availability of BT Sport channels makes BT's dual and triple-play SFBB packages more attractive.

7.54 Overall, Ofcom addresses a strategically critical and complex issue with a flawed and incomplete assessment of the relevant factors. BT's position about the inclusion of SFBB bundles with BT TV and/or BT Sport within the 'bright line' test has been set out in the preceding paragraphs in this section and this addresses many of the specific arguments raised by Ofcom. Nevertheless, BT sets out some brief comments on Ofcom's arguments below.

<u>The provision of SFBB triple-play bundles by BT's competitors is "wholly reliant" on the provision of VULA</u>

7.55 As set out above, BT does not deny that competitors without their own access infrastructure require access to VULA services to be able to offer SFBB triple-play propositions. However, Ofcom subsequently argues that because VULA is a necessary, albeit insufficient, input to supply dual-play <u>and</u> triple-play SFBB bundles, the same competition concern – that BT could use its SMP in WLA to distort competition downstream – applies across both, and that the same proposed <u>remedy</u> is therefore appropriate.

7.56 Critically, this apparent leap in logic ignores the fact that the nature of competition in the provision of triple-play bundles is radically different to dual play bundles, as set out in more detail in paragraphs 7.20-7.26. In particular, any ability BT <u>might</u> have to carry out a margin squeeze is substantially reduced given challenges it faces in competing against Sky. The risk of any margin squeeze is therefore much lower and the risk of Type 1 errors is higher. These points are not addressed by Ofcom's limited line of argument.

<u>BT's ability to circumvent the aims of the proposed SMP condition and exclude other operators from the triple-play segment</u>

7.57 Ofcom's issue in this regard appears to build on the general point Ofcom makes about bundles at paragraph 5.76 and footnote 245 of the Consultation. In paragraph 5.83 Ofcom argues that BT could set negative margin on its triple-play packages and a positive margin on its dual play packages, such that on an aggregate basis other operators would be unable to match BT's offers overall.

7.58 Under the proposed way forward set out at paragraphs 7.43-7.51 above, BT agrees that in assessing the costs of providing SFBB <u>dual play</u> services under a properly justified and formed MST, Ofcom would consider the costs and revenues of all elements of that bundle, i.e. including the supply of all call types, provision of hardware (such as a router) and software (such parental protection and/or cloud storage). Similarly, Ofcom would include the costs of any acquisition offers made to customers, such as the provision of vouchers. While those elements may not be offered by all competitors, they form part of the dual play proposition BT is offering. In these circumstances, the add-ons are individually low cost, are not related to any strategic longer term investment and are not affected by structural market entry issues. Including the current unit costs of supply of such add-ons in the bundle would therefore be reasonable.

7.59 However, for the reasons set out above, bundles including BT TV and BT Sport should not be assessed as part of the proposed 'bright line' test. The specific factors relevant to the nature of BT's intended longer term strategic investment and challenges faced in competing against heterogeneous offerings in a segment currently dominated by Sky mean that issues of both profit sacrifice and likely distortion are radically different in relation to triple-play compared to dual play. In particular, as set out in this Section, the risks of "Type 1" errors arising and preventing BT from benefiting from the investments made in TV and BT Sport are much higher for triple-play and should, therefore, be considered outside the scope of any 'bright line' test.

An inability to compete for SFBB customers seeking dual-play or triple-play bundles would affect general competition for SFBB customers

7.60 Ofcom appears to suggest that effective competition in the provision of SFBB services requires that all competitors are able to compete for both dual-play and triple-play bundles. However, as noted above and in Section 4, each operator has to date largely deployed their own successful and profitable strategies. Moreover, as set out in the Compass Lexecon paper enclosed at Annex C, these strategies are unlikely to require CPs to attract consumers who place a positive value on BT Sport.

The availability of BT Sport channels makes BT's dual and triple-play SFBB packages more attractive

7.61 BT accepts its current strategy seeks to extract value from the content it has acquired by: (i) selling the BT Sport channels on a stand-alone basis to residential and commercial customers; (ii) selling the BT Sport channels on wholesale terms to Virgin in the UK and Setanta in Ireland; and (iii) at the present time, providing the BT Sport channels at zero additional charge to its broadband customers to support acquisition and retention. BT does therefore believe that the availability of the BT Sport channels makes its SFBB packages more attractive.

7.62 However, this in itself says nothing about BT's ability to distort competition in SFBB as a result of the way it makes BT Sport available nor about the scale of the risk of it so doing. Ofcom's simplistic analysis fails to take account of the key issues set out in this Section.

Ofcom's treatment of SG+A

7.63 Finally, BT notes that Ofcom's proposed assessment of profit sacrifice in relation to BT Sport would also treat start-up costs in an inappropriate and inconsistent way, and risks double counting SG&A costs across its assessment of overall SFBB margin. Ofcom correctly recognises that BT faces one-off costs in launching the BT Sport business and that these costs should be recovered over a longer period of time. Ofcom suggests the appropriate period is three years, and in the Consultation suggests that an additional amount should be included until March 2016 to reflect these one-off costs. However, BT notes:

(a) Three years is an insufficient period of time over which to recover the start-up costs of this business given our intended longer term strategic objectives.

(b) Using Ofcom's proposed three years would lead to a significant over-recovery of the one-off costs far beyond March 2016 as Ofcom's MST assumes that these costs are incurred every month over the entire customer lifetime, assumed by Ofcom to be 60 months. In the extreme case of a customer acquired in March 2016, this customer would be required to recover a proportion of the start-up costs over another five years, i.e. until February 2021. For consistency, and notwithstanding BT's core concerns with Ofcom's approach, each customer should only recover one-off costs until March 2016. For example, a customer acquired in January 2015 should only recover start-up costs for the first 15 months of its customer life.

7.64 Due to BT Sport being in its start-up phase BT recognises that it will be unavoidable to rely, to some degree, on forecast data as opposed to audited management account data. This is because prices, customer volumes and costs will continue to evolve before reaching a sufficiently stable state that would allow the use of historical data to assess the most recent performance of BT Sport. However, using different data sources carries the inherent risk of double counting some common costs that also appear in the historical management accounts used for other parts of the VULA margin test. In the context of Ofcom's provisional NGFA decision, Ofcom noted a double counting of SG&A costs in the net costs of BT Sport but did not correct for the double count in all years. This would therefore need to be given explicit consideration in any assessment of profit sacrifice in relation to BT Sport.

Conclusion

7.65 BT considers that Ofcom has not assessed the issues raised in relation to the inclusion of BT TV and/or BT Sport within the 'bright line' test in any meaningful way. It is insufficient simply to include them in a crude fashion, on the sole basis that they form part of BT's SFBB portfolio. These are areas where BT has made (and is intending to make) long term strategic investments. However, Ofcom's proposed treatment of the unit costs of supplying these services would treat them in an inappropriately static and short term way. Indeed, Ofcom's failure to assess these factors adequately at this stage, and in particular the effect of its proposals on BT's investments in BT TV and BT Sport, is a key flaw in its assessment that leaves its conclusions in this regard unsustainable (see further Annex B for further detail).

7.66 Furthermore, consideration of likely distortion would also need to take account of the value customers attach to BT's specific offerings in a highly differentiate market and also have regard to Sky's position.

7.67 At the very least, Ofcom must recognise that the risk of 'Type 1' errors is higher for bundles including BT TV and BT Sport than for dual play bundles. These concerns, alongside the risk that BT is already, and would be even further unduly constrained in competing against Sky in triple-play bundles, supports BT's contention that Ofcom cannot consider any issues relevant to BT TV and/or BT Sport within the proposed MST. These complex matters would be more properly addressed under more flexible FRAND condition and/or competition law.

8. Ofcom's approach to VULA margin assessment and proposed treatment of specific cost items

Introduction and Summary

8.1 In Section 7, BT set out its proposed way forward that, at most, any 'bright line' test should focus exclusively on SFBB dual play offers without BT Sport. Other SFBB bundles would be assessed – if appropriate – within a clear effects-based framework under competition law and/or the existing FRAND SMP remedy applying to the provision of VULA.

8.2 However, any 'bright line' test applying to dual play offers must still be appropriately formulated to minimise the risk of Type 1 errors – i.e. where the design of the test would constrain BT's ability to price at levels that were unlikely to distort competition.

8.3 This Section focuses on the overall approach to assessing VULA margin Ofcom proposes in Section 5 of the Consultation and on its specific proposals for the treatment of costs and revenues within its test at Section 6.

Use of an adjusted EEO approach

8.4 In Section 5, we set out our objections to Ofcom's proposal to adopt Option 2 as the best means of achieving its overall aim of ensuring BT does not distort competition. Having chosen Option 2, it is inevitable that Ofcom then goes on to reject the use of an EEO standard. In this regard, BT refers to the points made at paragraphs 5.39 to 5.61 above.

8.5 Among other things, in Section 5 BT noted that Ofcom's choice of Option 2 was at odds with the Commission's Costing and Non-discrimination Recommendation. This document recommends that NRAs should use an EEO standard, and should only depart from that standard in very limited circumstances, none of which apply in the UK. Even if such circumstances were to apply in the UK, then Ofcom should still only make very limited adjustments.

8.6 In this regard, and as set out in further detail in Annex D, we note that Ofcom's approach also differs from that adopted in other EU Member States which have similar ex-ante MST regulatory experience. For example:

(a) In the Netherlands, where DSL entrants and cable operators have a relatively high market share, the NRA applies the same standards used in competition law, namely an EEO cost benchmark;

(b) In Austria, where cable operators enjoy a strong market position, the NRA applies an EEO cost benchmark.

8.7 This demonstrates that the EEO standard is seen as an appropriate measure of costs in countries with <u>less</u> competition than the UK and <u>without</u> an existing EoI framework.

8.8 It logically follows that we do not believe an adjusted EEO approach has been shown to be justified, nor that it is proportionate, because it is not necessary to support effective downstream competition. See further Annex B in this regard.

8.9 However, going beyond those over-arching contentions, BT submits that as a general principle in designing any margin test that includes adjustments which move the test away from an EEO standard, Ofcom should:

(a) Clearly evidence the adjustments it proposes to make to BT's costs, including why, for competition purposes, any adjustments are deemed appropriate. Such adjustments must have regard to the circumstances currently pertaining and likely to pertain in the foreseeable future. For instance, different operators may target different customer segments and, consequently, adopt very different pricing and/or proposition structures. They may therefore, as a result, experience different costs of supply and different revenue streams. Adjustments should not simply be applied to BT's numbers wherever Ofcom observes differences between BT and other operators in terms of unit costs and revenues, especially without (as on Ofcom's own admission) conducting an analysis of <u>overall</u> costs. They should be underpinned by objective analysis and identification of a structural problem that may give rise to clearly identified actual or potential foreclosure concerns from all or a critical part of the downstream market.

(b) Consider whether the overall impact of any adjustments (to reflect any areas where Ofcom believes adjustments are justified) are balanced against an assessment of areas where other operators may enjoy advantages relative to BT. For many cost items Ofcom has found that there is no cost difference between BT and rivals (or that it is very small); Ofcom therefore uses an EEO standard. In some cases (for example bandwidth costs and wholesale input costs), Ofcom has identified that BT's competitors may in fact have lower costs; however these are not used in Ofcom's MST and no provision is made for this cost advantage. Conversely, where Ofcom has identified what it deems to be a cost disadvantage (for example, ACL), this is taken into account directly in the MST. BT considers that this approach is inconsistent with Ofcom's stated objective.

8.10 Ofcom sets out the two considerations it will make in assessing whether specific adjustments should be made at paragraph 6.27. These considerations are applied when considering when and how to make any adjustments to BT's costs in Section 6 of the Consultation. Our specific comments in relation to the approach Ofcom proposes to take in establishing the ACL and proposing to introduce a floor on the cost of network bandwidth that should be used are set out further below in this Section.

Use of LRIC+ approach

8.11 BT does not challenge in principle the <u>proposal</u> to adopt a "LRIC+" approach within an ex ante margin assessment framework applying to dual play offers. However, this is clearly an area where establishing the required <u>level</u> of mark-up over LRIC (i.e. the "+") in too rigid a way would provide significant advantages to BT's competitors in this market review period and serve itself to distort efficient and effective competition.

8.12 In Section 6 of the Consultation, Ofcom proposes to state in its guidance that it would likely allocate identified fixed and common costs evenly across SBB and SFBB services. Such costs would then form part of the 'bright line' test such that BT would be required to recover from SFBB acquisition prices a specific level of fixed and common costs. However, BT's main competitors are all active across SBB and SFBB services. As such, they (but not BT) will have considerable flexibility in how they choose to recover fixed and common costs across these services, particularly if they are seeking to drive migration through acquisition offers at particular points in time. Ofcom's approach to assessing the reasonableness of the mark-up over LRIC that BT is required to recover from SFBB services should therefore allow for some account to be taken of how costs are recovered across SBB and SFBB services. To do otherwise would impose overly rigid constraints on BT.

8.13 In this context, BT challenges certain aspects of Ofcom's reasoning for generally supporting the LRIC+ approach over a LRIC standard, as set out in paragraphs 5.55 to 5.65 of the Consultation given that these may also inform Ofcom's proposals to establish, even in guidance, a very specific allocation approach. In particular:

(a) The level of mark-up should not, as suggested in the first bullet of paragraph 5.56, be set to meet an objective of <u>promoting</u> competition in SFBB services, when Ofcom's stated aim was to prevent BT <u>distorting</u> competition in SFBB services. BT's concern is that Ofcom adopts an approach to requiring a mark-up over LRIC which gives weight to a simple (and overly simplistic) observation that higher mark-ups will promote more competition over and above any specific consideration of static versus dynamic efficiency issues.

(b) The need to ensure fixed and common costs are recovered over the longer term (second bullet, paragraph 5.56) should not place rigid restrictions on the way in which such costs are recovered across services when setting acquisition prices in the short term. Ofcom appears to want to avoid a situation where common cost recovery "*shifts sharply*" as a result of short term prices not reflecting long term cost recovery requirements. However, that concern could be avoided by adopting some flexibility of approach over time – e.g. with lower levels of cost recovery on SFBB acquisition prices compared to other broadband prices. Also, Ofcom does not establish the circumstances which it believes could lead to shifts and unstable prices in a way that would actually lead to consumer harm.

(c) In terms of consistency (see paragraphs 5.57 to 5.60), BT's position is that Ofcom's common regulatory practice is to consider fully issues relating to economic efficiency in deciding what cost standard to apply in setting charge controls or establishing regulated price levels. While that has tended to support the use of fully allocated costs in setting charge controls or regulated prices, exceptions have been made following consideration of static and dynamic efficiency issues. Ofcom should therefore assess common cost recovery across SBB and SFBB services by reference to static and dynamic efficiency.

(d) Concerns with the consequences of errors in adopting a LRIC standard (paragraph 5.61) should not imply a more general need to establish a higher mark-up above LRIC. Ofcom rightly rejects TTG's proposal that it should "*aim up*" in assessing and adjusting BT's costs in a margin test. Ofcom should avoid positioning its LRIC+ standard as a means of doing precisely this. Furthermore, given that Ofcom's overall approach to designing the test is conservative – most notably because of its static nature – any concerns with ‘errors’ are likely to be overstated.

(e) Ofcom should be in a position to consider common cost recovery across SBB and SFBB fairly easily and such an exercise would not be “*complex and difficult to resolve*” as set out at paragraph 5.62.

8.14 Ofcom’s specific proposals for treating fixed and common costs are set out below.

8.15 Finally, and as set out in further detail at Annex D, we note that Ofcom’s approach differs from that adopted in other European countries which have similar ex-ante MST regulatory experience. Although these NRAs face different competitive conditions in each country, a common feature of the tests is the flexibility that has been built into the MST to reflect these varying levels of competition in different markets. For example, the choice of the cost benchmark and/or cost standard used in the MST will reflect the presence of competitive pressure imposed by cable operators (nationally or in some exchange areas) and/or higher levels of competition in the provision of unregulated services such as TV.

8.16 For example:

(a) In the Netherlands, where DSL entrants and cable operators have a relatively high market share, the NRA applies the same standards used in competition law, namely a long run incremental cost (LRIC) cost standard;

(b) In Ireland, where entrants have gained market share over the past few years and the cable operator (UPC) has a strong position (in areas where the cable network exists), the NRA provides the incumbent with more pricing flexibility in competitive areas;

(c) TV services, to the extent they are included in the MST, are generally included at their LRIC. For example, in Ireland, Spain and the Netherlands, NRAs include the LRIC of TV services in the MST; in Italy and Denmark, these costs are excluded from the product-by-product test and only included in the portfolio test at their LRIC; and in Austria, the NRA considers these services to be provided under competitive conditions and hence their revenues and costs are excluded from the MST.

Scope of the VULA margin assessment and the output increment

8.17 Section 7 of this Response considered specific issues relevant to Ofcom’s proposals to include pay TV and BT Sport within the scope of its VULA margin assessment. To be clear, therefore, BT’s comments on scope in this Section are restricted to the scope of dual play offers covered by any such assessment.

8.18 BT agrees that Ofcom should focus any MST on residential propositions. Ofcom’s analysis of competition is focussed on residential services and has not identified any specific risks in relation to business services that would support the need for an additional remedy over and above competition law and existing SMP remedies. Ofcom has the ability to consider any specific issues on a case by case basis under these existing requirements, taking full account of all relevant information, including in relation to market context, the strength of BT’s competitors and the likelihood of market distortion.

8.19 BT also agrees that Ofcom should consider the costs and revenues of the full range of services provided within BT's dual play offers – i.e. among other things, line rental, call package fees, out of package call revenues, additional bandwidth usage charges, hardware (e.g. wireless routers), software (e.g. parental protection), enhanced functionality (e.g. cloud storage, access to WiFi networks) in addition to any vouchers or gifts supplied at the point of acquisition.

8.20 However, BT's clear position is that this range of add-ons to dual play offers are <u>different</u> in nature to the provision of BT TV and/or BT Sport which raise a more complex set of competition issues as discussed in Section 7. All major broadband competitors will at least offer dual play offers – i.e. including narrowband services to support making and receiving fixed line calls – and tend to provide a similar, albeit not identical, range of ancillary and add-on services to support the delivery of the basic dual-play offer. In contrast to the issues presented by triple-play and BT Sport, there are also no market entry problems relating to the provision of those additional services which would complicate consideration of the underlying market distortion concern central to Ofcom's approach.

8.21 Finally, BT agrees that any assessment of margin should be conducted at the <u>overall</u> level of the fibre portfolio, not on individual services or groups of services within the portfolio. BT offers a range of fibre dual-play propositions based on Openreach's GEA inputs and these are broadly replicated by the offers seen in the market from BT's competitors. Different CPs may adopt different strategies to target particular customer segments, but all will face the challenge of driving volumes and recovering overall costs.

Need for an effects-based analysis

8.22 For the reasons set out in Section 7 above, BT accepts that if an appropriate test of BT's margin can be established in relation to dual play offers, then a separate effects based analysis would be unnecessary. This is because supply and demand conditions are closer to the 'pure vanilla' case where identification of profit sacrifice is indicative of foreclosure.

8.23 However, this does not mean that Ofcom should adopt a rigid approach to considering margin. The use of guidance alongside an SMP requirement should allow for a 'bright line' test that can be flexible to circumstances over the period of the charge control and not rigidly fixed from day one. Among other things, as detailed in this Section, Ofcom should allow for consideration of different means of recovering common costs across SBB and SFBB services and take account of forward-looking factors that could affect cost recovery across the expected customer life.

8.24 BT also notes that Ofcom rejects BT's previously expressed concerns that a margin test without an effects based analysis could lead to "*false positives*" by reference to a "*competition law assessment*" (see paragraph 5.137). In this response, BT has set out concerns with 'Type 1' errors. BT's concerns regarding such errors have been made by reference to Ofcom's stated overall aim in the Consultation: i.e. whether the test, as proposed, is only identifying and prohibiting SFBB prices that would otherwise distort competition.

Ofcom's overall approach to establishing the SMP remedy

8.25 BT noted in Section 7 that Ofcom's proposed SMP remedy establishes a static 'bright line' test of BT's margin. Specifically, Ofcom proposes that BT demonstrates that minimum margin is earned in an assessment period such that:

$$P - (W + DC) \geq (UC - UR)$$

i.e. BT passes the MST if the NPV of ongoing monthly margin on acquisition prices over a defined customer life of 60 months is greater than net upfront costs of acquiring customers.

8.26 By proposing to define the minimum margin requirement and the algebraic terms within the SMP remedy, Ofcom would appear to allow no account to be taken of how costs and revenues might reasonably be expected to change over the customer life. The test is therefore simply whether the monthly margin earned at the point of acquisition would be sufficient to recover the acquisition cost if that monthly margin remained flat throughout the customer life.

8.27 In fact, because Ofcom proposes to use the latest available actual information to assess costs along with actual revenue information from the assessment period under review, the MST is essentially backward looking. No account would even be taken of <u>known</u> changes to Openreach EoI charges, call termination charges or significant downward trends in network costs of bandwidth.

8.28 As set out in paragraph 7.33 above, the Commission's Costing and Non-discrimination Recommendation sets out, in Annex II, what it considers to be the relevant time period for evaluating the profitability of flagship products and the method that should be adopted. It states that it should be evaluated on the "*basis of a dynamic multi-period analysis*", suggesting that a forward looking approach is the appropriate means of assessing profitability.

8.29 BT understands that there is uncertainty in forecasting costs and revenues over time, but Ofcom's proposed approach would remove consideration of <u>any</u> forward-looking issues even in relation to <u>known</u> changes where forecasting presents less of an issue. In a competitive and dynamic retail market, BT's competitors will be setting prices on a forward looking basis and Ofcom should not establish constraints on BT in such an overly rigid way.

8.30 In this context, Ofcom's approach is out of step with tests applied by other NRAs such as Italy, Ireland, Spain, and Austria, each of which apply a forward-looking DCF approach with retrospective checks when considering incumbent's costs.

8.31 Further detail on the approaches adopted in other Member States is set out in Annex D.

Focus on new customers

8.32 BT agrees that a focus on the cohort of new customers is appropriate in considering whether BT's pricing of dual-play offers is likely to distort competition. However, such a focus emphasises the need to ensure that Ofcom's approach is truly forward looking and does not take an overly static view of unit costs and revenues that would understate the expected value all operators could derive from acquiring customers onto existing and new services.

8.33 As discussed above, the focus on the prices charged to new customers also supports a more flexible approach to common cost recovery across broadband offers to support migration from SBB to SFBB, and allow BT to adopt approaches that are open to its competitors.

Average customer lifetime

8.34 In the Consultation, Ofcom assumes that the ACL is 5 years when conducting its assessment (paragraph 6.238), despite evidence that BT's ACL for both SBB and SFBB is materially longer. According to Ofcom, its chosen figure of 5 years reflects the evidence of a "*material difference*" between BT's SBB ACL and that of other operators (paragraph 2.232).

8.35 BT submits that Ofcom's adoption of an ACL of 5 years based on SBB churn rates is clearly flawed, for the following reasons:

(a) Ofcom has incorrectly dismissed BT's SFBB churn rates for estimating future ACL;

(b) Including TV and BT Sport further reduces churn;

(c) Other CPs have lower churn than the figures assumed by Ofcom;

(d) Ofcom is wrong to dismiss Virgin's churn as irrelevant; and

(e) The use of an average for comparing ACL is not appropriate given recent data and likely future trends.

<u>Ofcom has incorrectly dismissed BT's SFBB churn rates for estimating future ACL</u>

8.36 Ofcom dismisses data provided by BT relating to its churn figures for SFBB due to (i) alleged volatility in the data due to a small sample base and (ii) bias downwards due to the relatively large proportion of SFBB customers who are still within minimum contract terms (paragraph 6.228). Ofcom also concludes that it is unlikely that there will be "*large changes*" in ACL between SBB and SFBB.

8.37 Ofcom's reasons for concluding that SFBB churn figures are not a "*good estimator*" of future SFBB ACL are flawed.

8.38 First, BT has offered SFBB products for four years and its fibre base stood at over 2 million from early May 2014. Contract terms are typically 12-18 months and approximately [ ] BT's fibre base are currently out of contract. It cannot credibly be said that such figures represent a "*small sample base*". CONFIDENTIAL

8.39 Secondly, even when comparing churn rates between copper and fibre broadband on a like-for-like basis for different cohorts of customers (e.g. in contract vs out of contract), the data still shows that fibre has materially lower churn than copper. This is demonstrated in the table below[66] which shows that, <u>even accounting for other</u>

[66] The data provided is a recent snapshot of churn performance on the entire Broadband base and therefore includes the impact of BT Sport and BT TV sales. The results differ slightly from the date previously provided

factors such as the number of customers in contract, BT's fibre ACL is longer than copper.

All ADSL	In contract	[ ]%
	Out of contract	[ ]%
	Blended	[ ]%
All SFBB	In contract	[ ]%
	Out of contract	[ ]%
	Blended	[ ]%
SFBB advantage	In contract	[ ]%
	Out of contract	[ ]%
	Blended	[ ]%

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8.40 Thirdly, Ofcom fails to recognise that fibre broadband is inherently a more compelling product than copper, with better speeds and, consequently, happier customers who tend to be more loyal. BT's longer fibre ACL reflects the better overall service which its Infinity product provides. Customer surveys carried out by BT on a monthly basis consistently show that fibre customers are more satisfied than copper customers. For example, in the 12 months from July 2013 to June 2014, on average [ ]% of BT's fibre customers were either "*extremely satisfied*" or "*very satisfied*" with their broadband service. This compares with an average of [ ]% for copper customers over the same period. CONFIDENTIAL

8.41 Fourthly, reflecting the inherent benefits brought about by fibre, BT's internal planning budgets have in the past and continue to forecast a clear positive delta between fibre and copper churn rates, albeit diminishing over time as other CPs continue to ramp up their own fibre roll out plans (described further in Section 4 above).

8.42 Fifthly, it is not just BT that considers that fibre products are likely to have lower churn than copper equivalents. Indeed TTG itself acknowledges the benefits that fibre will bring with respect to reducing churn. For example, it has stated:

(a) fibre customers have "*reduced churn and costs to serve*"; and

(b) "*Net promoter scores (NPS) from customers taking additional products such as TV, mobile and fibre remained significantly above those from dual play customers, with early life churn materially lower*".[67]

8.43 Finally, Ofcom also agrees that fibre broadband is likely to generate higher customer satisfaction levels – and therefore lower churn – than copper broadband. In its Communications Report 2013 it stated as follows:

to Ofcom in that it only went up to Q4 12/13. Blended churn from Q4 12/13 was [ ]% on ADSL and [ ]% on SFBB. Over the subsequent year [ ]. CONFIDENTIAL

[67] TalkTalk Telecom Group PLC, *Interim Management Statement for the 3 months to 30 June 2014 (Q1 FY15)*, 23 July 2014.

> "*Overall satisfaction levels, along with satisfaction with downstream and upstream connection speeds, and the value for money of their service, were higher among superfast than non-superfast users in almost all cases. […] In the UK, 89% of superfast broadband users were happy with their overall service in September 2013, the highest proportion among our comparator countries*."[68]

8.44 This theme was carried forward in its Communications Report 2014, where it noted as follows:

> "*The proportion of adults who were 'very' satisfied with the speed of their fixed broadband service increased by 6pp to 47% in the year to Q1 2014. The driver behind this is likely to be higher average connection speeds as a result of the growing take-up of superfast broadband services […]*"[69]

8.45 As Ofcom itself notes in the consultation (see footnote 441), evidence that longer ACL reflected superior service would undermine its rationale for making any adjustment. It is therefore clear that Ofcom has incorrectly dismissed BT's SFBB churn rates for estimating future ACL. Instead of relying on inaccurate and out of date SBB churn figures, Ofcom should reflect in its analysis BT's latest available SFBB churn data.

<u>Including TV and BT Sport further reduces churn</u>

8.46 In the MST, Ofcom proposes to include the costs and revenues attributable to BT's triple-play fibre packages and BT Sport. In contrast, its ACL analysis focusses exclusively on SBB broadband, thereby failing to capture the positive impact of triple-play and BT Sport on churn.

8.47 BT's data clearly demonstrate the positive impact of BT Sport on churn rates. The figures show that a newly acquired Infinity customer who takes Sport will be [ ]% CONFIDENTIAL less likely to churn than a customer who does not take Sport. Similarly, a newly acquired copper broadband customer who takes Sport will be [ ]% less likely to churn than a customer who does not take Sport. Overall, from the announcement of BT Sport churn has improved by c. [ ]%, with Q4 of 2013/14 [ ]% better than the prior year.

8.48 This view is reflected in BT's monthly customer surveys, which show that since the launch of BT Sport in August 2013, on average [ ]% of BT's fibre customers who CONFIDENTIAL also subscribed to BT Sport were either "*extremely satisfied*" or "*very satisfied*" with their broadband service. This compares with an average of [ ]% for fibre-only customers over the same period. A similar trend emerges with respect to copper customers, with values of [ ]% and [ ]%, respectively.

8.49 A compelling TV proposition also significantly reduces overall levels of churn. While BT has yet to surmount fully certain challenges with respect to its TV proposition (as described in Sections 4 and 7 above), it expects that over time its churn rate (similar to TTG and Sky) will fall further, due to the beneficial impact of TV and Sport. Indeed BT has recently experienced materially improving churn rates

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[68] Ofcom, *The Communications Market Report*, 1 August 2013, Figure 6.6.
[69] Ofcom, *The Communications Market Report*, 7 August 2014, page 359.

for its TV customers, on the back of its investments in the YouView platform. For example, churn rates on TV customers fell from [ ]% in Q1 of 2013/14 to [ ]% in Q1 of 2014/15. BT expects these rates to fall further as it improves its TV offering. CONFIDENTIAL

8.50 The improved churn benefit provided by TV and Sport is reflected by the recent data in the table below:

Product	**All customers**	**Dual Play + Sport**	**Dual Play + TV + Sport**
Copper (blended)	[ ]%	[ ]%	[ ]%
Fibre (blended)	[ ]%	[ ]%	[ ]%

8.51 Again, the beneficial impact on churn of triple-play packages is recognised by others within the industry. For example, TTG recently noted the following:

> "*[...] the high levels of satisfaction with their service that our TV customers are reporting, and the consistency of their content purchasing behaviour, has translated into <u>materially lower early life churn than for their dual play counterparts</u>. Average monthly churn on the TV base through FY14 was approximately half that seen from our dual-play base. The lower early-life churn, significantly higher NPS and lower surveyed propensity to churn, give us a great deal of confidence that <u>mature triple-play customers will also churn at a materially lower rate than dual-play customers</u>.*"

> "*We have continued to see <u>materially lower churn from customers taking additional products such as TV, mobile and fibre</u>. The most important effect is seen in our <u>triple play customers whose early life churn is around half that of dual play customers</u>, with TV customers also reporting higher net promoter scores and lower intention to churn.*"[70]

8.52 Ofcom needs to reflect the positive churn benefits brought about by TV and Sport. To do otherwise, while at the same time requiring BT to recover the costs of TV and net costs of BT Sport as part of its test, would amount to cherry picking.

<u>Other CPs have materially lower churn rates than the figures assumed by Ofcom</u>

8.53 In light of published data on churn rates, it is unclear to BT how Ofcom can conclude that Sky and TTG, in particular, have materially higher churn than BT when measured on a like-for-like basis.

8.54 For example, Sky's latest results showed that while its levels of churn had increased in 2014, rates were still very low at 10.7%. Sky's reported churn rates in 2012 were as low as 9.9%.

8.55 TTG's latest results reported reducing churn, at 1.4% per month (or 16.8% annually), compared to 1.5% for the previous quarter and 1.4% for the same quarter last year. Factors supporting lower churn were said by TTG to include the following:

[70] TalkTalk Telecom Group PLC, *Preliminary results for the 12 months to 31 March 2014 (FY14)*, 15 May 2014.

(a) Continued growth of the TV base, which comes with a longer 18-24 month contract and increased customer satisfaction;

(b) Continued upselling of mobile into the base, which drastically reduces churn;

(c) Growth of the fibre base, which makes customers more inert whilst also enabling TV adoption; and

(d) Reduced churn on the on-net base.

8.56 Moreover, TTG has firm aspirations to reduce its churn even further. In its March 2014 results announcement, it noted the following:

> "*We have begun to see the impact of [TV customers] in our reported on-net churn which, having spiked at 1.7% in Q2 subsequently fell to 1.6% in Q3 and 1.5% in Q4. As an illustration, reducing churn to 1.2% (the top end of the 0.8%-1.2% range that mature triple-play operators report) over the next three years, driven primarily by driving TV penetration across the base and further improving customer service, would lead to a cumulative saving of c£30m over the period through fewer gross adds*."[71]

8.57 It is therefore clear that the churn rates reported by TTG, which are already lower than Ofcom's assumed rates, are expected to fall further as it expands penetration of TV to its broadband base.

Ofcom is wrong to dismiss Virgin's churn as irrelevant

8.58 Even though it accepts that Virgin is part of the same retail broadband market as other CPs, Ofcom considers that Virgin's ACL is unlikely to be a good guide to the ACL of operators purchasing VULA from BT (paragraph 6.233). Ofcom's reasons include the fact that Virgin is a vertically integrated operator which does not rely on VULA and that switching between Virgin and a VULA-based CP may involve more inconvenience that switching between providers using the Openreach network.

8.59 However this neglects to address the more fundamental point noted above that increased speeds, such as those offered on the Virgin network, can equate to reduced churn and increased ACL. In its latest results, Virgin noted that its annual churn had remained relatively stable, at 14.7%, again significantly lower than the figure assumed by Ofcom in its consultation.

The use of a historic average for comparing ACL is not appropriate given recent trends

8.60 At paragraph 6.232, Ofcom states that is has particularly focused on the experience of Sky and TTG, based on data relating to their average respective ACLs between Q1 2011 and Q2 2013. The most recent data relied upon by Ofcom is therefore already nearly 12 months old.

8.61 The use of an average over two years from 2011 is inappropriate given that there has been a clear upward trajectory in terms of BT's ACL over time. The data relied upon by Ofcom should be updated given recent trends.

[71] Ibid.

8.62 It is also important to reflect the fact that churn rates generally across the industry are falling, and expected to continue to do so. As noted above, TTG has publically committed to reducing its levels of churn.

8.63 Finally under this heading, BT notes that TTG's comments that BT's SFBB churn will be "*distorted*" if BT is engaging in a margin squeeze should be dismissed without more, given Ofcom's provisional findings in its investigation under the Competition Act.

Summary and conclusions on ACL

8.64 It is clear from the points noted above that Ofcom's decision to assume an ACL of 5 years when conducting its VULA assessment is inappropriate.

8.65 BT submits that Ofcom should at the very least properly reflect in its assessment the inherent advantage fibre customers provide in terms of churn. It should also update its analysis to reflect general industry trends towards longer ACL. Moreover, to the extent that Ofcom has decided to conduct its assessment including BT's TV and Sport propositions, it should concomitantly extend its assumed ACL to reflect the benefits those propositions offer in terms of increased customer satisfaction.

Network costs – unit bandwidth charges

Ofcom's rationale for the proposed floor

8.66 In paragraphs 6.71 to 6.75 of the Consultation, Ofcom explains why it provisionally considers that it is appropriate to set a minimum unit bandwidth cost – i.e. establish a "*floor*" for the level of such costs to use in the MST – based on Ofcom's assessment of the costs faced by BT's competitors when assessing the VULA margin. This is on the basis that unit bandwidth costs:

(a) comprise a large proportion of downstream costs;

(b) have been variable in the past;

(c) are a unique source of economies of scale for BT; and

(d) other CPs have some slight commercial drawback relative to BT.

8.67 BT disagrees with Ofcom's reasoning and that costs in the margin test should be the higher of the Regulatory Financial Statements ("**RFS**") costs or the "*floor*".

8.68 In terms of Ofcom's first reason, the significance of network costs, if anything, demonstrates the importance of using the right level of cost. Otherwise, it would make the cost of the regulatory failure which might arise from setting an inappropriate floor particularly distortionary. Whilst Ofcom has explained its choice of a floor as being based on an adjusted EEO standard, using Sky and TTG's costs as understood by Ofcom, the derivation of the costs themselves lacks transparency. This omission is particularly unsatisfactory as it is proposed that these costs are then to be 'hard wired' into the new SMP condition.

8.69 Second, whilst BT has made changes to the calculation of network costs in the 2013/14 RFS, this was to update the RFS to reflect better cost causality in a fast evolving part of BT's network. Furthermore, any future changes to cost methodologies used in producing RFS estimates are to be subject to Ofcom's prior agreement, following changes to the process by which changes to the RFS are introduced. Thus cost methodology changes will have to be accepted by Ofcom as being valid and justified.

8.70 Third, Ofcom has found no evidence that BT has lower unit costs due to economies of scale and thus the third reason Ofcom gives is just speculation (something Ofcom only states as being a "*possibility*"). Nor is speculation about unspecified "*slight commercial drawbacks*" an objective reason to use a cost floor which Ofcom has not transparently justified.

8.71 BT therefore considers that Ofcom ought to use BT's RFS costs as the basis for its calculations and not establish a lower bound on such costs in each year of this market review period within the MST.

8.72 Moreover, whilst a floor is inappropriate, it is also not clear from the Consultation how exactly Ofcom intends to use the floor compared to the RFS cost. The latter is only known historically, so if one considers, for example, 2016/17, BT will then only have data for 2015/16 (and even that data will not be available until 3 months into the year in question). However, in the Consultation, Ofcom shows a floor for 2016/17. BT assumes this must be for comparison with RFS data, but this will not be available until 2017/18 - i.e. beyond the period being considered by Ofcom. Further explanation from Ofcom is therefore needed.

<u>Use of BT's RFS data requires adjustments</u>

8.73 Ofcom's proposal to use BT's RFS costs for WBC bandwidth in Market 3 to assess the unit cost of bandwidth for providing SFBB services requires adjustments as the data actually relates to SBB services.

8.74 Specifically, in BT's regulatory accounting system, backhaul costs are calculated on an EoI basis, reflecting the prices charged by Openreach for the backhaul services. There are two types of backhaul used by the WBA markets as reported in the regulatory accounts, namely:

(a) Ethernet Backhaul Direct ("**EBD**"), which is used to connect the Ethernet Switch nodes to Metro nodes; and

(b) Ethernet Access Direct ("**EAD**"), which is used to connect the remote copper MSAN nodes to Ethernet Switch nodes.

8.75 SBB services use EAD links to carry traffic originating on remote MSANs (i.e. not collocated with Ethernet switches). By contrast, SFBB nodes are all collocated at Ethernet Switch nodes, and they do not therefore need to use EAD links to reach those nodes. Hence in the regulatory accounting system, EAD is only allocated on the basis of SBB WBA traffic and not SFBB traffic. For 2013/14, the removal of EAD from the fibre cost results in a reduction of approximately £[ ] per Mb per month. CONFIDENTIAL

8.76 Further, whilst both SBB and SFBB use EBD links, SFBB nodes are only present at a sub-set of Ethernet Switch nodes. These fibre nodes have higher traffic levels and better network economics. Therefore the unit costs of EBD will be lower for SFBB than for SBB.

SG&A costs / Network Rental Overhead

8.77 In paragraph 6.91 of the Consultation, Ofcom outlines that it will request data from BT Wholesale to estimate the network rental overheads of serving a SFBB customer. BT understands that Ofcom has used BT's bottom-up estimate of these costs in its VULA margin assessment.

8.78 Ofcom is now proposing to estimate bandwidth costs using information from BT's regulatory financial system for Market 3 (now Market B) WBC. However this figure already includes costs of an "*SG&A component*", which itself includes costs relating to BT Wholesale network overheads of serving a fibre broadband customer. In 2013/14, this amounted to approximately £[ ] per Mb/s. Without any offset, there will CONFIDENTIAL be a double count of costs, given that SG&A costs are already included in the bottom-up calculation. If it is to be adopted, the bottom-up estimate also needs to be updated, as the current estimate was calculated for the 2012/13 financial year and some of the costs will decline year on year.

Forward looking view

8.79 Ofcom accepts that unit bandwidth costs are falling over time. While BT has reservations about the way Ofcom has derived year-on-year reductions in unit costs, the acceptance of the direction of travel presents a clear issue in relation to the static approach to assessing cost recovery Ofcom is planning to take.

8.80 Ofcom's approach should therefore reflect the reality that BT and all its competitors have constructed networks to meet the projected growing demand for bandwidth and, as these are utilised, unit costs will fall. Ofcom should at least ensure that any guidance notes this point and allows for flexibility in the approach to be adopted.

Aggregation Links

8.81 Ofcom has explained (at paragraph 6.60 of the Consultation) that MSILs are required to serve as transmission bearers between aggregation points and BT's core network. In fact, BT uses a mixture of MSILs at some aggregation points, and Cable Links at others.

8.82 The MSIL and Cable Link costs are not included in the Market 3 WBC Bandwidth service since they are not part of a WBC service and these costs therefore need to be assessed based on measuring the volumes of MSILs / Cable Links being used to support broadband traffic. Because the use of Cable Links gives a more efficient cost structure than using MSILs alone, these are being increasingly deployed and should result in material cost savings.

8.83 Consistent with the use of assumed cost regressions for backhaul, Ofcom should also consider therefore how these will change over time.

End-user bandwidth usage

8.84 To preserve consistency, Ofcom ought to use both costs and average end-user usage levels from the same period, whether adopting historic or forward-looking information. RFS data (which is always historic and not published until 3 months after the year in question has finished) could either be used to derive end-user bandwidth costs using usage for that historic year or, if up to date usage is to be used, then the anticipated rate of on-going cost reductions would need to be factored in.

Treatment of shared and common costs and SG&A costs

8.85 In Section 6 of the Consultation, Ofcom discusses the treatment of shared and common costs as part of the discussion around the recovery of SG&A costs. SG&A costs include a significant share of costs which are fixed and common – e.g. accommodation costs and other overheads for the BT Consumer business. This is therefore the key area where Ofcom establishes the detail of how it believes SFBB services should recover a mark-up over LRIC for fixed and common costs – i.e. “LRIC+”.

8.86 For on-going SG&A costs, Ofcom identifies that some costs will be incremental whereas others will be fixed and common across the entirety of BT Group. Ofcom continues that, based on its conclusion that LRIC+ is the appropriate cost standard to use to assess the VULA margin, a proportion of the total SG&A costs should therefore be allocated to the SFBB stack. Ofcom does not specifically identify different cost items or types of cost as ‘incremental’ or ‘fixed and common’ in the Consultation. However, in its provisional NGFA decision, Ofcom effectively treated all SG&A cost items, except TSO fixed costs, as incremental (i.e. variable with the number of customers and/or volume of individual products supplied), on the basis that those cost items were at least scalable.

8.87 In paras 6.107 and 6.108 of the Consultation, Ofcom sets out two different approaches to allocating each SG&A cost category: the first is by product, based on the fact that the management accounts cover all the products BT Consumer supplies; and the second is per customer, which TTG expressed as the most appropriate allocation. Ofcom states it would use the two different approaches depending on whether a cost was principally driven by the number of customers being served or the number of products being sold.

8.88 Under the approach set out in the draft guidance in Annex 6 to the Consultation, Ofcom would first allocate costs on the basis of BT’s internal operational systems where BT holds a reasonable breakdown of these costs on individual product lines. Where Ofcom does not believe this to be the case it will use the customer/product approach. Draft Guidance Table 3 sets out Ofcom’s allocation approaches for each SG&A cost category.

8.89 For up-front SG&A costs, Ofcom considers, in paragraph 6.214, that a customer-based allocation is likely to be appropriate, as most of these costs are unlikely to vary significantly with the number of products a customer takes.

8.90 BT has concerns with the binary nature of Ofcom’s treatment of shared costs and approach to scalability. In particular, costs such as customer service overheads, accommodation and total labour costs are not variable in the way Ofcom has assumed – at least in the period of the current market review. Ofcom’s assumption that these costs are fully scalable is a significant over-simplification of how the costs would differ – and the speed at which they could be flexed – with the size of BT’s SFBB business.

8.91 The choice of the product-based method is particularly likely to overstate the costs allocated to SFBB services compared to the customer-based approach. It is unlikely, for instance, that costs such as customer service and labour costs increase linearly with number of products - i.e. a dual-play customer is unlikely to use a call centre twice as intensely as a single-play customer. Ofcom's approach effectively assumes that economies of scope from bundling services are non-existent and takes no account of possible differences in attitudes across customer types (e.g. voice-only users may be more likely to contact a call centre than double-play users who could use internet-based troubleshooting tools).

8.92 To demonstrate the general concern, BT has compared Consumer SG&A costs, in aggregate, for 2012/13, 2013/14 and forecast 2014/15 with Infinity product volumes to ascertain whether costs have increased in line with Infinity volumes. This assessment shows that whereas BT Consumer's SG&A costs have only increased between [ ]% year-on-year over the time period, SFBB and overall broadband volumes have increased at a substantially higher rate over the same period. CONFIDENTIAL

8.93 As discussed above, BT accepts that including some mark-up above LRIC in an ex ante assessment is valid, so does not generally challenge the use of the LRIC+ standard. However, BT is concerned with the rigidity of approach Ofcom is proposing to take. In particular, Ofcom's methodology allocates fixed and common costs within SG&A equally to customers taking dual play SBB offers and those taking dual play SFBB offers. As Ofcom's guidance is non-binding, BT would always expect some flexibility in Ofcom's approach when actually considering BT's pricing. However, Ofcom should amend its guidance to acknowledge explicitly the fact that some degree of flexibility in how BT recovers these fixed and common costs across SBB and SFBB services may be warranted.

8.94 In the model used in Ofcom's provisional NGFA decision, Ofcom's allocation of SG&A costs to SFBB dual play offers was £[ ] per subscriber month. By implication, the model would allocate the same unit cost to each SBB dual play subscriber. As noted, Ofcom's simplified approach to scalability means that while the NGFA model is nominally assessing BT's margin against a LRIC standard, these SG&A unit costs will include some costs which are fixed and common. Furthermore, TSO fixed costs, which were considered to be fixed and common within the NGFA model, would be allocated to SFBB dual play offers in the LRIC+ ex ante approach. This would bring £[ ] into the SFBB stack. CONFIDENTIAL

8.95 To the extent that Ofcom found that BT 'passed' the dual play test as designed – i.e. on the basis of the specific allocations of fixed and common costs – then no competition issues would arise. However, if BT 'failed' the test within the margins of these fixed and common costs – i.e. based on the assessment carried out at the time in Ofcom's provisional NGFA decision, £[ ] plus some share of £[ ] – then some further consideration should be given to how those costs are being recovered over SBB and SFBB services, as well as from new customers and existing customers. A strict 'bright line' approach that prevented BT setting prices within these margins in any circumstances would be unduly rigid and unjustified as an ex ante requirement based on any analysis Ofcom has conducted. CONFIDENTIAL

Ofcom's estimate of the effects of its proposals and consistency with its objectives

8.96 At paragraphs 6.240 to 6.264 of the Consultation Ofcom assesses the overall effects of its proposals and the whether these are consistent with its objectives. Ofcom identifies that the adjustments made to the EEO LRIC standard used in its provisional NGFA decision amount to £2.50-£3.50 per subscriber per month – i.e. adjustments resulting from reducing customer life by 6 months, including fixed and common costs within SG&A allocations and network costs of bandwidth.

8.97 Ofcom then assesses whether its proposals – which Ofcom states at paragraph 6.249 would affect BT's margin "*by a few pounds per subscriber per month*" – would address its stated objective. BT makes the following comments:

(a) Ofcom's assessment is conducted not against the overall aim of whether BT is prevented from distorting competition, but whether a "*slightly higher cost*" operator would be able to profitably match BT's SFBB offers. As previously stated in Section 5 above, this is not the correct reference point against which to assess the effectiveness and proportionality of Ofcom's proposals.

(b) Ofcom does no more than highlight the benefit that BT's competitors would derive from the "*protection*" offered to them by requiring BT to earn margin above the LRIC EEO threshold. The fact that BT's competitors will benefit is indisputable and says nothing about whether the proposals themselves are <u>necessary and proportionate</u> to address the identified objective.

(c) Ofcom effectively ignores the relevance of the very evidence it presents in Table 6.10 and paragraphs 6.257 to 6.264 – i.e. that BT's competitors, including TalkTalk and Sky, are <u>already</u> more than matching BT's SFBB offers. Taken with the public statements from TalkTalk and Sky on the profitability of SFBB services set out in Section 4 above, this evidence in fact further supports BT's case that the current set of commercial, regulatory and legal constraints faced by BT must be sufficient. Ofcom refers to the fact that TalkTalk and Sky will be able to "*maintain their price advantage*" over BT, but makes no comment on the fact that the existence of an advantage in the first place may undermine the very basis on which Ofcom considers the constraints on BT to be necessary and proportionate.

8.98 BT's position is that Ofcom's assessment exposes that the provision of the additional protection offered by Ofcom's proposed approach simply provides an unwarranted leg-up to BT's competitors.

Conclusions and assessment of the true impact of Ofcom's proposals on competition and consumers

8.99 Ofcom's proposals – even if restricted to SFBB dual play offers without BT Sport as submitted by BT in Section 7 – would require BT to earn a level of margin on its SFBB portfolio that is in excess of the level actually needed to ensure competition is not distorted, i.e. the level at which BT's competitors would still be able to purchase VULA and offer profitable and competitive SFBB offerings. For the reasons set out in this Response, this is because:

(a) Ofcom has taken a static view of cost and revenues at the point of acquisition in a dynamic market place where BT's competitors will take a long term view of the value of acquiring customers; and

(b) Even on that static view, Ofcom is proposing to take an approach to key parameters that would overstate the recurring margin BT would need to make over a customer lifetime.

8.100 Specifically, in relation to (b), Ofcom's proposed approach would :

(a) Understate the ACL BT would expect in acquiring SFBB customers. Based on the analysis set out in this Section, BT submits that ACL should be at least [ ] longer than proposed. This adjustment alone would reduce the recurring margin requirement by about £[ ]. CONFIDENTIAL

(b) Overstate the cost of network bandwidth by: (i) including the costs of EBDs in assessing costs for SFBB services rather than the cost of EADs; and (ii) double counting SG&A costs. Correcting these would remove £[ ] from the per Mb cost of bandwidth and, therefore, about £[ ] from the network cost included in the unit cost stack for an SFBB subscriber. CONFIDENTIAL

8.101 In other words, Ofcom's approach, as proposed, would require BT to make an <u>additional</u> £[ ] extra margin over and above the level that any competitor would require to profitably match its prices, <u>even</u> on Ofcom's static view.

8.102 Furthermore, Ofcom's proposes to constrain the way in which BT recovers fixed and common costs from across its broadband customers when setting SFBB acquisition prices, even though BT's competitors would face no such constraints. Some flexibility in the recovery of costs which are, at a minimum, £[ ] per subscriber per month is therefore justified. CONFIDENTIAL

8.103 Ofcom must recognise that setting a margin requirements in this way – even if restricted to dual play offers – would likely have a detrimental effect on consumers. Ofcom's regulation will invite competitors to regard BT as the price leader for SFBB and for other market prices to be set from this level. This will dilute the effects of the competition Ofcom is seeking to promote. BT's margins and prices are restricted and competitors are likely to undercut only to the extent they calculate maximises their profits. Customers will, therefore, actually be <u>denied</u> the full benefits of competition as a result of Ofcom's proposed MST.

8.104 On the basis of forecast SFBB connections (on the Openreach network alone) of about [ ] by the end of this market review period, BT estimates that consumer prices could be <u>over £150m a year</u> higher than they would need to be to ensure effective competition (even under Ofcom's proposed static approach). Taking a dynamic view would increase this number further. BT's competitors will inevitably be the main beneficiaries of this unwarranted level of protection as they will be able to attract customers at prices that are higher than the efficient level. CONFIDENTIAL

8.105 This situation would be made even worse if Ofcom were to proceed with its proposal to include BT TV and BT Sport within its 'bright line' test of margin. The Report from Compass Lexecon at Annex C highlights that, based on Ofcom's assessment of the net cost of BT Sport per subscriber in the Competition Act investigation, Ofcom's approach could require BT to maintain an additional margin of around £[ ] per CONFIDENTIAL month or £100m per annum over its customer base at the end of 2014 (i.e. when Ofcom conducted its Competition Act assessment). However the Compass Lexecon report also indicates that this margin protection is unlikely to be required by BT's competitors to enable them to reach minimum efficient scale and compete for the provision of SFBB services.

8.106 A specific margin requirement of the level described would risk raising SFBB prices across the market as the effects of competition are diluted and competitors seek to undercut BT but maintain prices above the long term competitive levels. Again, based on forecast SFBB volumes on the Openreach network of 7 million in 2016/17, any requirement to maintain a margin in the region of £[ ] per month could result in prices that are an additional £350-400m above levels required to support competition (again, taking a purely static view). CONFIDENTIAL

8.107 Against this backdrop of significant consumer detriment during this market review period, it is notable and surprising that in concluding on the effects of its proposals, Ofcom makes no attempt to quantify the 'trade-off' between the protection it is offering BT's competitors and likely impacts on the effectiveness of competition.

8.108 In summary, BT fundamentally disagrees with Ofcom's conclusions at paragraphs 6.257-6.264 of the Consultation. Rather than proving "*protection*" to TTG and Sky to allow them to compete effectively against BT, Ofcom's proposals would instead provide them with an unwarranted regulatory pricing 'umbrella' under which they could seek shelter, ultimately leading to inflated prices to consumers running to hundreds of millions of pounds.

9. Conclusions and Proposed Next Steps

9.1 For the reasons set out in this Response, BT considers that Ofcom has not justified the imposition of the MST - either at all or in the form proposed. In particular, Ofcom has not met the relevant jurisdictional threshold to set such a condition and, in any event, the MST would not be a proportionate way to address Ofcom's regulatory objective. Ofcom should instead rely on a combination of the existing FRAND condition, supported, if necessary with guidance, as well as ex post competition law.

9.2 Were Ofcom minded to continue to proceed to adopt an MST, it should re-consider the available evidence, including that set out in this Response, and re-consult on its revised provisional conclusions.

9.3 Without prejudice to BT's primary submissions above and to the extent that Ofcom can properly establish that a MST of some sort justified based on a through market analysis, this would only stand a chance of clearing the relevant thresholds if it was to be restricted to dual play, and based on an EEO standard.

9.4 Furthermore, if Ofcom can in due course justify the imposition of a dual play MST, Ofcom would also need to:

(a) Reflect the forward looking nature of the test;

(b) Allocate SG&A costs appropriately;

(c) Reflect the true costs of bandwidth;

(d) Capture the ACL for BT's SFBB customers.

9.5 BT's clear position is that it is not appropriate to include BT Sport and TV within any ex ante margin squeeze test. However, to the extent that Ofcom can properly establish that, as a matter of jurisdiction and proportionality, the unrecovered costs of BT Sport and BT TV cannot be entirely excluded from an ex ante MST, Ofcom would nonetheless need to review fundamentally its approach to cost recovery, as well as giving full weight to a carefully considered effects analysis in the event of any failure of a bright line test.

ANNEX A: BT's responses to Ofcom's Consultation Questions

Ofcom Question	BT Response
Q2.1 Do you consider that there has been a material change in circumstances in the WLA market since the 2014 FAMR Statement? Please provide supporting evidence as necessary.	BT does not consider that there has been a material change in circumstances in the WLA market since the 2014 FAMR Statement.
Q3.1 Do you agree with our proposed regulatory objective for the VULA margin? Please provide reasons in support of your view.	For the reasons provided in Section 5 of this Response, BT does not agree with Ofcom's proposed regulatory objective for the VULA margin.
Q4.1 Do you agree with the proposed form of the VULA margin requirement and associated compliance monitoring? Please provide reasons in support of your views.	For the reasons provided in Section 6 of this Response, BT does not agree with Ofcom's proposed regulatory objective for the VULA margin.
Q5.1 Do you agree with our approach to the VULA margin assessment? In particular, do you agree that we should: (a) adopt an adjusted EEO approach? (b) assess costs on a LRIC+ basis? (c) assess costs and revenues at the level of the entire portfolio of superfast broadband packages marketed at residential consumers and taking into account the components of these packages? Please provide reasons in support of your view.	For the reasons provided in Section 8 of this Response: (a) BT does not agree that Ofcom should adopt an adjusted EEO approach; (b) BT does not agree that Ofcom should assess costs on a LRIC+ basis; and (c) BT agrees that Ofcom should assess costs and revenues at the level of the entire portfolio of superfast broadband packages marketed at residential consumers, subject to BT's submissions in relation to BT Sport and BT TV in Section 7.
Q6.1 Do you agree with the details of how we propose to treat costs and revenues? In particular, do you agree: (a) with our draft guidance, particularly the proposed guidance in relation to BT Sport? (b) with the adjustment to average customer lifetimes in the proposed SMP condition? (c) with the floor on unit bandwidth costs in the proposed SMP condition? (d) that overall our proposals are likely to meet our objective? Please provide reasons in support of your view.	BT's response to Q6.1 is set out in this Response, in particular Sections 7 and 8. In particular: (a) BT does not agree with Ofcom's draft guidance, particularly the proposed guidance in relation to BT Sport (see Section 7); (b) BT does not agree with the adjustment to average customer lifetimes in the proposed SMP condition (see Section 8); (c) BT does not agree with the floor on unit bandwidth costs in the proposed SMP condition (see Section 8); and (d) BT does not agree that overall Ofcom's proposals are likely to meet its objective (see Sections 5 and 8).

ANNEX B: BT's submissions on the applicable legal framework

[Please refer to separate document accompanying this Response]

ANNEX C: Compass Lexecon report entitled "*The appropriate economic treatment of BT Sport in VULA margin regulation*"

[Please refer to separate document accompanying this Response]

ANNEX D: Margin squeeze test implementation by other NRAs in Europe

[Please refer to separate document accompanying this Response]

ANNEX E: Examples of recent SFBB and SBB promotions

[Please refer to separate document accompanying this Response]