KCOM Group PLC

Fixed Access Market Reviews
Approach to the VULA Margin

Response by KCOM

28 August 2014

Introduction

KCOM previously provided limited comments on the issue of VULA margin in response to Ofcom's July 2013 Fixed Access Market Reviews consultation.[1] Those comments were provided in the context of a proposal to supplement an obligation on BT to provide VULA on fair and reasonable terms and conditions (including charges) with guidance on how Ofcom would be likely to undertake an assessment when testing whether the VULA margin complied with that SMP condition.

In our response we noted that while Ofcom's proposals related to the market for VULA in the UK outside the Hull area, we were concerned about the potential for Ofcom to fetter its discretion in relation to how it would, should it ever need to, interpret ex-post margin squeeze under competition law or the proposed ex-ante fair and reasonable charges obligations imposed on KCOM.

Ofcom is now proposing to impose a specific obligation on BT in respect of VULA margin using a separate SMP condition supplemented by guidance on how an assessment of compliance with the condition would likely be undertaken. We acknowledge this is a different approach to that we previously commented on and in some ways is less problematic in terms of precedent. Nevertheless, we have serious reservations regarding the appropriateness of Ofcom's move to regulate VULA margin in this way and its potential impact on the wider market.

We do not intend to comment specifically on Ofcom's proposed approach to VULA margin assessment or the proposed treatment of costs and revenues. Rather our response deals with the general concept of imposing an express SMP condition defining what is acceptable in terms of margin.

[1] http://stakeholders.ofcom.org.uk/binaries/consultations/fixed-access-market-reviews/responses/KCOM.pdf

KCOM Fibre Investment

In July 2011 KCOM announced plans for an initial deployment of a broadband fibre access network to 15,000 homes in the Hull area over an 18 month period. Our first customers were connected in September 2011 on a trial basis and we formally launched KC Lightstream and KC Lightstream Business services in January 2012 (www.kc.co.uk/lightstream). In October 2012, KC completed its initial deployment of superfast fibre technology successfully and our next phase of the deployment of fibre currently being undertaken will pass a further 30,000 homes and businesses by March 2015. Our technology of choice for the delivery of superfast broadband services is Fibre to the Premises (FTTP). We expect decisions on further investment to be made in the not too distant future.

This is a significant investment in fibre access and without a regulatory environment that encourages infrastructure investment it simply would not be an attractive or viable option. Given our market position in Hull, in developing our investment plans we have been mindful of Ofcom's approach to the regulation of BT's fibre services. The economics of NGA are challenging and the regulatory framework has a fundamental impact on decisions regarding deployment of superfast broadband services and the development of competition in the UK broadband market. Clearly any commercial investor contemplating entering this market, including KCOM, will be concerned that their legitimate commercial returns may be eroded by regulatory remedies.

Therefore while Ofcom's proposals in respect of VULA margin are focused on BT, Ofcom's approach will certainly be a relevant consideration for KCOM and our future investment plans, with the potential to directly impact KCOM's own incentives to rollout fibre in the Hull area.

Price Regulation of Fibre

KCOM supports the general approach to VULA pricing which Ofcom has articulated in the Fixed Access Market Review 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."[2]

As Ofcom acknowledges, in order to avoid damaging the prospects for such investment it is important that appropriate economic signals are sent. In regulatory terms, we believe that a flexible approach to the pricing of wholesale products is vital, allowing a higher cost of capital, which reflects the real risks of speculative investment. We believe the provision of services should always be subject to a reasonable demand test and full cost recovery.

However, we are concerned that by imposing a specific SMP condition regulating BT's VULA margin, Ofcom is effectively introducing a form of price control in all but name – a retail minus approach which has been used in the past rather the cost plus pricing regulation which is now more commonly used.

We do not believe VULA is at the right point in its life cycle to require formal price regulation. Incentives to deploy network remain vital to support modernisation of the UK communications infrastructure, to ensure the Government's commitment to making the UK the best connected country in the world is achievable and that the target of providing 95% of the UK population with access to superfast broadband by 2017 can be met. Superfast broadband services provided over next generation access were available to 78% of UK premises by June 2014[3] while at the same time there were 6.1 million UK superfast broadband connections[4]. The introduction of a price constraint mechanism which could result in price increases for consumers and/or a reduction in wholesale revenues for those investing in networks has the very real potential to harm both investment and uptake.

Ofcom needs to consider the impact its approach with BT would have on a wider superfast broadband market. Not everything is delivered over Openreach infrastructure and Ofcom's approach to the regulation of VULA will be a very real consideration for other providers such as KCOM. At the very least Ofcom should assess the potential impact of its proposals for other providers and in particular, any unique circumstances such as those which exist in Hull where the imposition of regulatory remedies can ultimately affect consumer welfare when other providers choose not to enter the market.

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[2] Para 1.35 http://stakeholders.ofcom.org.uk/binaries/telecoms/ga/fixed-access-market-reviews-2014/statement-june-2014/volume1.pdf

[3] P 22 http://stakeholders.ofcom.org.uk/binaries/research/cmr/cmr14/2014_UK_CMR.pdf

[4] P 25 http://stakeholders.ofcom.org.uk/binaries/research/cmr/cmr14/2014_UK_CMR.pdf

Issues with Ofcom's chosen device

In addition to the existing fair and reasonable charges ex ante SMP condition, Ofcom has robust competition law powers to test for anti-competitive margin squeeze, based on the equality efficient operator (EEO) approach.

Even if one accepts price intervention is required at this early stage of the VULA product life cycle, KCOM is very uncomfortable with the approach which Ofcom is now proposing. We consider there are considerable risks if Ofcom opts to deviate from this approach adjusting margin requirements to allow for a higher cost operator. While we are not commenting on the specifics of Ofcom's adjustments in its modelling, we have serious concerns this higher cost approach would problematically adjust BT's incentives. The proposed condition would be imposed in the Wholesale Local Access (WLA) market, yet has the potential to impact directly on other markets, where BT does not hold SMP, which Ofcom has not considered in any detail.

Ofcom's proposal means there will be three levers that BT could use to ensure that the VULA margin condition is met. Decrease wholesale pricing, increase retail pricing, or cut retail costs. Each of these raises issues not just in relation to retail services based on BT's VULA product, but also in the wider NGA market.

Decrease wholesale pricing

This has the potential to devalue fibre and significantly reduce the incentives to invest in NGA. This is an issue not only for BT but for all providers who are investing in fibre. We have set out our concerns in this respect above.

Increase retail pricing

If retail prices are increased more than they otherwise would be due the SMP condition, it could result in consumer harm. While the retail market is a relevant factor to consider in wholesale SMP regulation, Ofcom has gone a step further in proposing remedies that directly apply at the retail level without carrying out a detailed analysis of the retail market. As acknowledged by Ofcom "…requiring BT to set a VULA margin greater than required by competition law implies that it either must increase its retail prices (which harms consumers, at least in the short term) or reduce its wholesale VULA price (which affects its investment incentives) or some combination of the two."[5]

Cut retail costs

Competitive pressure could well result in cutting retail costs becoming a more attractive approach to compliance with the condition for BT. We would be concerned that the incentive on BT to cut its retail costs could be strong under Ofcom's proposals. Innovation in the applications delivered over fibre is vital in driving take-up of

[5] Para 11.343 http://stakeholders.ofcom.org.uk/binaries/consultations/fixed-access-market-reviews/summary/fixed-access-markets.pdf

superfast broadband. Higher take-up in turn increases the incentives of all fibre providers to invest in further roll-out. By constraining BT's retail cost base beyond EEO margin squeeze under competition law it could reduce BT's incentive to offer attractive applications at the retail level.

In particular, it is uncomfortable Ofcom would seek to involve itself in BT's retail approach to issues connected to sports rights as part of a market review looking at wholesale fixed access. Yet the proposed inclusion of these costs means that the proposed VULA margin condition has the potential to have a direct impact on the decisions which BT takes in this area. We make no comment on Ofcom's proposal to include these costs in assessing VULA margin, rather our concern is the appropriateness of imposing a remedy in the WLA market which could have a direct impact on this area.

We believe if Ofcom finds grounds to impose ex ante regulation applying to a particular BT wholesale product, the preference must be to use regulation where the incentives focus on the upstream operation of BT. It should not pursue a remedy which directly impacts other areas of BT's business where BT does not have SMP.

Ofcom has rejected the idea of relying on competition law to act as a constraint on the VULA margin yet TalkTalk's margin squeeze complaint highlighted that it does provide a remedy when retail behaviour is problematic. In that particular case Ofcom's provisional decision found no evidence of margin squeeze which begs the question of what issue Ofcom is attempting to resolve by imposing an SMP condition regulating VULA margin.

Given the fact alternative providers using VULA do have lower retail pricing than BT, we cannot see there is an issue here of margin or retail level competition. Rather if BT's market share in Openreach delivered fibre is organic, something which more detailed analysis of the retail market could confirm.

Ofcom must allow the superfast broadband market to develop naturally rather than try to pre-judge it. Ofcom has appropriate competition law powers to address any market failure, and must remember that BT is not currently unconstrained in relation to pricing. It has a fair and reasonable charges obligation and is subject to ex post competition including EEO margin squeeze. Ofcom does not need to constrain BT further, particularly not through the use of a mechanism that has impacts far beyond the WLA market in which it will be imposed, and has the potential to impact on the decisions being taken by the wider market in relation to fibre investment.