BSKYB'S RESPONSE TO OFCOM'S CONSULTATION:

FIXED ACCESS MARKET REVIEWS: APPROACH TO THE VULA MARGIN

1. Introduction

1.1 This submission comprises Sky's response to Ofcom's consultation on the proposed introduction of an SMP condition on BT to maintain a minimum VULA margin (the "VULA margin condition") and guidance on how compliance with the VULA margin condition would be assessed by Ofcom (the "VULA margin test").

2. Ofcom's proposal to introduce the condition and provide guidance is necessary and proportionate

2.1 As Ofcom recognises, we are now in a period of transition in relation to broadband services, with consumers and small businesses moving from standard broadband to superfast broadband services.[1] Ofcom has characterised this period as one of "*disruption*"[2], representing a heightened opportunity for retailers to compete for new subscribers. As a result, the development of a competitive market for the provision of superfast broadband services is a key issue facing both the UK telecommunications sector, and the UK economy more generally.

2.2 Over the past decade the UK has benefited significantly from strong competition in the provision of standard broadband services, based to a significant extent on competitors' investments in alternative infrastructure. Currently, the economics of providing superfast broadband services based on alternative infrastructure investment on a widespread geographic basis are challenging, and are likely to remain so over the period covered by the Fixed Access Market Review ("FAMR"). This leaves competing providers who want to offer a national superfast broadband service reliant on 'end-to-end' wholesale products provided by BT.

2.3 As Ofcom recognises, the combination of (i) BT's SMP in the market for wholesale local access ("WLA") (in which it has a "*very high*" and stable market share in excess of 80% and where Ofcom finds that entry barriers are also "*very high*" [3]), (ii) its vertical integration, and (iii) the opportunity to re-establish a dominant market position at the retail level afforded by the transition from standard to superfast broadband services, creates the clear risk that BT will distort effective competition at the retail level in the provision of superfast broadband services. Ofcom's consultation makes it clear that BT is fully cognisant of the opportunity it currently faces to re-establish a strong downstream position in broadband services. BT is currently winning a "*substantial*" share of VULA-based superfast broadband

[1] See, for example, paragraph 3.44. All paragraph references are to the consultation document unless otherwise stated.

[2] Paragraph 3.45.

[3] Paragraph 2.21.

subscribers, retailing nearly 80% of all VULA-based superfast broadband connections[4]. Ofcom has evidence that BT expects to build a substantial base of superfast broadband subscribers during the review period.[5]

2.4 Strong downstream competition in standard broadband services in the UK has driven take-up, and resulted in low prices and high quality services for UK consumers and small businesses. It has also meant that the issue of net neutrality has not been as significant an issue in the UK as other countries. Issues such as an ISP seeking to block or degrade access to services delivered via the internet are of less significance when consumers have an effective choice among a number of competing suppliers of internet access.

2.5 Ofcom's proposal is a proportionate way of protecting against the risk that these benefits are unwound as a result of BT acting in a way that reduces the competition that it faces at the retail level of the market.[6, 7]

3. Ofcom should implement the VULA margin condition as soon as possible

3.1 It is increasingly clear that BT is seeking to use the period prior to the introduction of the VULA margin condition to acquire as many superfast broadband customers as possible, regardless of their profitability. By way of example, in the past few weeks BT has introduced new offers that include:

- BT's Infinity 1 (up to 38Mb/s download speed) package, with a £125 Sainsbury's voucher at £5 per month for six months, together with free BT Sport; and
- Plusnet's up to 38 Mb/s download speed package (with no usage cap) for £3.75 per month for six months.

3.2 Sky's analysis of the profitability and payback periods for these offers is set out at **Annex 1**. It shows that the payback period on these types of customers is very long – far longer than the five year average customer life used by Ofcom in the VULA margin test.

3.3 Accordingly, if as the result of consultation Ofcom confirms that it is necessary and proportionate to implement its proposals, it should do so as soon as possible.

4. Ofcom must ensure that the proposed remedy is effective

4.1 Having determined that regulatory intervention is appropriate, and given the importance of a competitive market for the provision of superfast broadband services to the UK economy, Ofcom must ensure that it will be effective in meeting Ofcom's stated objective – namely, 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*"[8]

---

4 Paragraph 3.61.

5 See, for example, paragraphs 3.64 – 3.70, which appear to indicate that BT forecasts that it will achieve a high share of superfast broadband customers.

6 Sky notes that the benefits to BT from reduced competition at the retail level are not limited to profits on supplying superfast broadband services. Because superfast broadband services are bundled with other communications products – notably line rental and calls – when a customer switches to BT for superfast broadband, BT also earns additional profits from these services.

7 As set out in Sky's response to Ofcom's July 2013 consultation on this issue, Sky considers that the appropriate approach to use for the VULA margin test is an equally efficient operator ("EEO") approach. The comments provided in this response on Ofcom's proposals, which are based on an "adjusted EEO" approach, are without prejudice to this view.

8 Paragraph 1.8.

4.2 As Sky set out in its previous responses to Ofcom's July 2013 on the VULA margin test consultation, one of the most obvious ways for BT to undermine the effectiveness of the proposed regulation is to bundle valuable products with superfast broadband, at no additional charge to consumers.[9] In Sky's view, that proposition is not contentious. Indeed, it is an argument that BT has endorsed strongly in other contexts[10]. Accordingly, we welcome Ofcom's acknowledgement of this risk, and its proposal to include BT Sport in the test.

4.3 BT Sport is not a special case. All products and services that are bundled with the provision of superfast broadband services should be included in the test, particularly if they are provided below cost. Accordingly, Sky welcomes Ofcom's recognition that its guidance may need to be altered to include other products and services in future.[11]

4.4 More generally, the relative novelty of the regulation and its multifaceted nature are likely to provide opportunities for BT to undermine its effectiveness in ways that are difficult to anticipate. It will be important, therefore, for Ofcom to remain vigilant against such behaviour, and, if such attempts emerge, address them quickly.

5. Treatment of common costs associated with bandwidth

5.1 The cost of bandwidth is a significant component of the cost of providing superfast broadband services. Ofcom recognises that BT's ability to alter the allocation of common costs associated with provision of backhaul and core bandwidth to its broadband customers in its regulatory accounts gives BT significant scope to undermine the effectiveness of the VULA margin test. As Ofcom notes:

> "*if BT alters its cost allocations in its regulatory financial reporting system such that unit bandwidth costs are materially lower, this could materially reduce the minimum VULA margin*." [12]

5.2 In order to constrain BT's ability to act in this way, Ofcom proposes to set annual "floors" (based on estimates of rivals' unit bandwidth costs), which decrease over time. As Ofcom further notes, however, there is likely to be a significant gap between BT's unit bandwidth costs based on current common cost allocations and these floors, thereby affording BT significant ability to "*materially reduce the minimum VULA margin*" – simply as a result of changing cost allocations in its accounts.

Ofcom's proposed approach is inappropriate

5.3 The cost allocations set out in BT's regulatory financial reporting system reflect decisions taken by BT about the most appropriate way of distributing those costs, based on a set of underlying principles.[13] BT should of course be permitted to change its approach to

---

9 See, in particular, Sky's response to Ofcom's July 2013 FAMR consultation document entitled 'Appropriate scope of products included in Ofcom's proposed VULA margin test', December 2013. Available at: http://stakeholders.ofcom.org.uk/binaries/consultations/fixed-access-market-reviews/responses/Sky_Appropriate_Scope_of_Products_Included_in_Ofcoms_Proposed_VULA_Margin_Test.pdf.

10 *Ibid.*

11 See paragraphs 4.53 and 4.57, and footnotes 138 and 141. In particular, there is considerable speculation that BT may launch a consumer mobile telephony service in the near future. If it were to do so and the service was bundled with superfast broadband, it would be appropriate to include it in the VULA margin test.

12 Paragraph 6.73.

13 Indeed, in the BES case before the CAT, in relation to the issue of BT's discretion to adjust cost allocations in its regulatory accounts, a witness for BT stated: "*…we actually take great care in actually selecting the appropriate attribution methodology. So by definition in the end the one that we choose at that particular time was the one that we feel is the most fair and agrees with the principles of, as I have said, cost causality and objectiveness.*" (Paragraph 108 of the BES judgment: *BT & ORs v. Ofcom;* Cases 1205-1207/3/3/13 [2014] CAT 14.)

allocating common costs if there is a good reason for adopting a different approach to that which it currently uses. However, permitting BT to adopt a new approach to common cost allocation, the principal purpose of which is to reduce the constraint imposed by the VULA margin test, would be inappropriate. Instead, for consistency BT should be required to maintain current allocations unless it provides compelling reasons for adopting a different (and consistent) set of allocations to Ofcom.

5.4 This is consistent with current Ofcom policy in relation to BT's regulatory accounting. In previous regulatory decisions Ofcom has recognised the issues that can arise from simply accepting BT's cost allocation changes and has demonstrated that it is willing and able to review and reject allocation changes if it is concerned about the basis for those changes[14]. This policy has now been formalised with the introduction of a new change control process that gives Ofcom the power to reject cost allocation changes proposed by BT – with Ofcom stating that "*we will where we consider it necessary, block changes proposed by BT*"[15].

5.5 Allowing BT simply to change its approach to common cost allocation in order to relax the VULA margin test also:

5.5.1 risks undermining previous regulatory assessments and decisions that were predicated on the original common cost allocations. In particular some of the common costs currently attributed to the core network category and hence to bandwidth (such as the costs of ducts and fibre in the core network) are likely to be shared with other services. Any material reduction in common costs allocated to bandwidth could therefore increase significantly the costs allocated to other products. As a result, cost allocation changes could undermine previous regulatory decisions, for example those relating to market power assessments, charge controls, and cost orientation conditions which were predicated on particular allocations of common costs[16]; and

5.5.2 undermines the confidence that other communications providers can place in the information provided in BT's regulatory financial reporting. As Ofcom has recognised, the confidence that competing communications providers have in the data in BT's regulatory financial statements plays an important role in providing them with assurance that BT is complying with its regulatory obligations.[17] Material

---

14 For example, Ofcom decided to use BT's 2011/12 Regulatory Financial Statements and cost allocations for the base year costs for setting charge controls in the 2014 FAMR, rather than those for 2012/13 which it deemed inappropriate. Ofcom stated:

> "*the 2012/13 RFS contain material cost allocation methodology changes when compared to the 2011/12 RFS which, our analysis demonstrates, would result in significant over-recovery of costs for BT. Our analysis also raised concerns regarding the balance of the review leading to the changes in allocation methodology*." (Paragraph A22.2, Annex 22, Fixed access market reviews: wholesale local access, wholesale fixed analogue exchange lines, ISDN2 and ISDN30, Statement, 26 June 2014. Available at: http://stakeholders.ofcom.org.uk/binaries/telecoms/ga/fixed-access-market-reviews-2014/statement-june-2014/annexes.pdf)

15 Paragraph 1.12, 'Regulatory Financial Reporting, Final Statement', Ofcom, 20 May 2014.

16 One such example is the Wholesale Broadband Access Market Review in which Ofcom concluded that BT has significant market power in certain wholesale broadband access markets and, as a result, imposed a series of SMP conditions on BT. These included a charge control and an obligation for certain charges to be cost oriented. It is likely that BT services that are subject to the charge control and cost orientation condition share core network common costs with BT's superfast broadband services. Similarly, in rejecting the changes to cost allocations made by BT to its 2012/13 Regulatory Financial Statements as the basis for setting charge controls in the 2014 FAMR, Ofcom stated:

> *"using the 2013 RFS as presented would result in the significant over-recovery of costs for BT. This is because costs that have been included in other recently set charge controls (e.g. leased lines) are now being allocated to services within the scope of the proposed Charge Controls."* (Paragraph 7.92, Fixed access market reviews: wholesale local access, wholesale fixed analogue exchange lines, ISDN2 and ISDN30, Consultation Document, 19 December 2013.)

17 See paragraph 1.6, 'Regulatory Financial Reporting, Final Statement', Ofcom, 20 May 2014.

changes in allocations, made principally in order to reduce the constraint that the VULA margin test imposes on BT's business, risk undermining regulatory certainty.

Adjustments to the cost floors

5.6 If Ofcom concludes that its proposed approach remains appropriate, Ofcom should adjust the proposed floors for bandwidth costs to include (a) colocation costs, and (b) an allocation of group overhead costs.

5.7 Ofcom's approach to calculating the permitted 'floors' for BT's bandwidth costs to be used in the VULA margin test is to base those floors on the per-customer costs of bandwidth incurred by BT's retail competitors. In calculating those floors, however, Ofcom has removed the costs of colocation in BT exchanges when calculating Sky's bandwidth costs and it does not appear that colocation costs are taken account of elsewhere in the VULA margin test. Colocation costs are the costs incurred by communications providers associated with locating their equipment in BT exchanges in order to connect to the local access network and to provide broadband services. Colocation is a material component of communications providers' cost of providing bandwidth to superfast broadband subscribers. Accordingly, colocation costs should be included in the cost floors.

5.8 Based on data previously provided to Ofcom by Sky, in 2012/13 this cost was on average c£[CONFIDENTIAL] per month when considered on a per Mbit basis (equivalent to £[CONFIDENTIAL] per subscriber per month).

5.9 Second, Ofcom's analysis does not include any allocation of group overheads in its estimate of Sky's bandwidth costs. BT's costs attributed to the core network category, and therefore to bandwidth, in its regulatory financial statements are likely to include an allocation of BT's group overheads. Group overhead costs include, for example, finance, human resources and legal costs. Other operators also incur their own group overhead costs and therefore, if any floor on bandwidth costs is to reflect the costs of other operators, it should include an allocation of the other operators' group overheads.

5.10 Sky estimates this allocation of group overheads to bandwidth costs to be £[CONFIDENTIAL] per Mbit per month in 2012/13, or £[CONFIDENTIAL] per subscriber. [CONFIDENTIAL].

6. The net cost approach to inclusion of BT Sport costs in the test

6.1 Ofcom proposes to include the "net costs" of BT Sport in the VULA margin test - *i.e.*, the total costs of producing and distributing the BT Sport channels, net of any revenues received in relation to those channels.[18]

6.2 As explained further below, Sky considers that this approach may be reasonable in certain circumstances – particularly where BT Sport is considered to be attractive to relatively small proportion of households intending to subscribe to superfast broadband services, and downstream competitors may be able to use other products to compete for such customers. As Ofcom recognises in the consultation, however, market circumstances can change significantly in a short period of time. The potential exists for BT Sport to become a more significant determinant of the choices of a larger number of superfast broadband subscribers, in which case the 'net costs' approach may no longer be appropriate.

6.3 At the outset, Sky notes that the most obvious approach to determining an appropriate input price for BT Sport for the purpose of a test of a margin that enables effective retail competition is to use information on prices actually paid by downstream competitors, to

[18] For completeness Sky notes that in a number of instances Ofcom describes wholesale supply of BT Sport as "*sublicensing*" (*e.g.*, paragraph 6.201). Use of this term is erroneous. Wholesale supply comprises licensing of BT Sport, not sub-licensing.

the extent that such prices exist. At the time of Ofcom's July 2013 consultation on this issue it appeared to that there were no such charges that could be used in this way. [CONFIDENTIAL].[19] [CONFIDENTIAL].

6.4 More generally, the reasonableness of the use of the net cost approach depends on two key factors: (i) the significance of the product being bundled with superfast broadband (*i.e.*, in this case BT Sport) to competition at the downstream level, and (ii) whether there are adequate substitutes for the product being bundled with superfast broadband (in the sense of there being alternative products that downstream competitors can use to compete with bundles of superfast broadband and the product being bundled with superfast broadband services, supplied by BT). (For ease of exposition, in the following we focus on the case of bundling by BT of superfast broadband and BT Sport.)

6.5 The net cost approach may be reasonable in circumstances where downstream firms are able to spend similar amounts to the 'net cost' of BT Sport on alternative products that appeal to similar numbers or groups of end-users. In those circumstances downstream rivals should be able to compete effectively even if they are not able to access BT Sport, or can access it on terms that are less favourable than the implicit charge to BT's retail business used in the VULA margin test (the net cost of BT Sport).

6.6 This is not the case, however, where BT Sport (i) is a key determinant of the choice of provider of superfast broadband packages for a significant number of consumers and (ii) competing retailers do not have other products available to them which appeal to this group of customers. In those circumstances use of the net costs of BT Sport in the VULA margin test may not enable effective competition on the downstream market.

6.7 This may be the case from 2015, when BT will have exclusive rights to broadcast Champions League football and a significant number of Premier League matches (including first pick matches) in the UK. Moreover, there is clearly a possibility that BT could acquire more or even the majority of packages of live Premier League rights in the forthcoming auction.[20] BT's approach to the acquisition of Champions League rights in 2013 demonstrates that it is willing and able to bid aggressively to acquire premium sports content. If this occurred, from 2015/16 onwards BT could be the broadcaster of the majority of live Premier League football matches and all Champions League matches in the UK. Such a proposition plainly would appeal to a significant number of potential customers.

6.8 There are two possible scenarios in those circumstances.

6.9 First, BT may choose to supply BT Sport to downstream competitors on a wholesale basis. In this situation, the relevant charge to be used in the VULA margin test is the wholesale charge paid by third parties. A situation in which downstream competitors were charged, for example, £20 per month for BT Sport and the notional wholesale charge used in the VULA test was £10 per month (determined using the net cost approach) would not meet the test's objective of enabling effective downstream competition.

6.10 Second, BT may adopt an approach of offering BT Sport to consumers (i) in bundles with superfast broadband, and (ii) on a standalone basis, as it does currently with BT Sport on Sky's DTH satellite platform, and not wholesaling the product to downstream competitors. In this situation, consumers who prefer the superfast broadband services of a competitor to those of BT must "self-assemble" the bundle, *i.e.*, to take superfast broadband services from their preferred retailer, and BT Sport from BT. This would afford BT the ability to

19 [CONFIDENTIAL].

20 For example, BT's Chief Executive, Gavin Patterson, said in relation to the forthcoming auction of live Premier League rights: *"We can go for same as today or potentially go up to bidding for everything. There is a range of options we can look at"*. 'BT braced to take on Sky for Premier League football rights', Financial Times, 15 August 2014. Available at: http://www.ft.com/cms/s/0/47f3dbcc-246c-11e4-ae78-00144feabdc0.html#axzz3BU5XVndd.

distort effective retail competition by setting a high standalone price for BT Sport in order to make purchasing the bundle from BT a far more attractive option for consumers.[21] As a result, even if downstream competitors matched BT's prices for superfast broadband they are unlikely to be able to compete effectively for consumers who have a demand for superfast broadband and the content carried on BT Sport. In this situation, the appropriate figure to use as the notional input price for BT Sport in the VULA margin test would be the standalone retail price for BT Sport.[22]

6.11 Ofcom has recognised in the consultation that there may be circumstances in which the net cost approach is no longer appropriate as a result of changes in the way BT distributes its channels (see for example paragraphs 6.128 and 6.141). Ofcom should equally recognise that an alternative to the net cost approach may need to be implemented in the event of other changes in circumstances, such as those outlined above. In view of the potential for harm to downstream competition in these circumstances, if the SMP condition and guidance risked becoming ineffective or inappropriate, Ofcom would need to be capable of adjusting its approach within a short period of time. This will be much easier where Ofcom has signalled in advance what its likely approach would be if changes of this type to BT Sport were to occur.

7. Amortisation period for BT Sport rights costs

7.1 Ofcom proposes to amortise the cost of sports rights acquired by BT over the period of each rights contract. Sky agrees with this approach for the following reasons.[23]

7.2 First, this reflects the standard accounting treatment of programme rights costs, which is based on the principle that assets should be expensed over the period of their useful economic lives. There is no sound reason to believe that sports rights have a value to BT's business that extends beyond the period of each rights contract. Both Sky and BT adopt the same approach to amortising and expensing the cost of rights over the period of each rights contract in their published accounts. BT's accounting policies state:

> "*Programme rights are recognised on the balance sheet from the point at which the legally enforceable licence period begins…. Programme rights are initially recognised at cost and are amortised from the point at which they are available for use, on a straight line basis over the programming period, or the remaining licence term, as appropriate. The amortisation charge is recorded within operating costs in the income statement.*"[24]

7.3 This approach is consistent with that adopted by Ofcom in relation to expensing of the

---

21 For example, BT may set (i) a price for superfast broadband (with talk and line rental) of £25 per month, (ii) a standalone price for BT Sport of £15 per month, and (iii) a price for a bundle of superfast broadband, talk, line rental and BT Sport of £30 per month. In this situation, even if a competitor sets a price for superfast broadband (with talk and line rental) of £25 per month, they will not be able to attract customers who also have a demand for BT Sport.

22 For example, if, as in footnote 20, BT set a price for superfast broadband (with talk and line rental) of £25 per month, and a standalone price for BT Sport of £15 per month the amount that should be included in the VULA margin test for BT Sport is £15 per month.

23 Sky agrees with Ofcom that the one-off start-up costs of BT Sport should not be required to be recovered immediately.

24 Page 111, BT Group plc Annual Report & Form 20-F, 2013.

value of intangible assets in past decisions.[25]

7.4 Second, we consider that Ofcom's argument that adopting an alternative approach, which allocated a share of the cost of rights to future periods, "*is likely to be difficult and prone to errors*"[26] is broadly correct. In fact, there is a significant risk that such an approach would result in allocations of cost to future periods that would, to a large extent, be arbitrary in nature. Sky also agrees that alternatives to the standard accounting treatment of these costs would be "*potentially subject to gaming*"[27].

7.5 Finally, it is important to have regard to the approach used by BT to monetise the rights that it has acquired. A potential rationale for spreading some of the cost of rights into the future is that, as a new entrant to pay TV, BT should not be expected to earn a normal return on its investments over the first three years of its operation.

7.6 BT is, however, not acting as a normal new entrant into pay TV broadcasting, seeking to monetise its rights through standard revenues streams such as subscription, wholesale revenues and advertising. Instead, a key element of the rationale for BT's investment in sports rights is to drive revenue and profits in its telecommunications business. [CONFIDENTIAL][28]. [CONFIDENTIAL][29]. [CONFIDENTIAL][30]. [CONFIDENTIAL].[31]

7.7 As Ofcom is well aware, BT is not a new entrant into the telecommunications sector. It is a large, well established incumbent in that sector, with substantial accumulated assets and experience. As a result, it is entirely reasonable to expect that BT should be in a position to earn a return on the content rights that it has acquired over the period covered by those rights.

8. Recovery of marketing costs

8.1 Currently, and over the period covered by the FAMR, marketing of superfast broadband services is likely to comprise a high proportion of BT's total marketing budget (which itself is substantial).[32] Ofcom's proposed approach to such marketing costs aggregates all BT's consumer marketing, and spreads it over all acquisitions within each period. This enables BT, in effect, to allocate a share of the costs of acquiring superfast broadband customers to other services. This approach is inappropriate. Instead, the costs of marketing superfast broadband services should be identified separately and the full amount included in the VULA margin test.

Sky **August 2014**

[25] See, for example, the treatment of BT's development costs in the Freeserve case. Ofcom stated:

> "*Development costs can be considered to comprise strategic developments designed to create competitive advantage and ongoing development costs designed to prolong the life of existing assets. Ofcom would normally expect both types of expenditure to be capitalised and amortised over time reflecting the useful economic life of the asset…. Ofcom has amortised development costs over three years. This is considered by Ofcom to be a reasonable period for amortising costs in respect of "new economy businesses" in immature markets and complies with BT's published accounting policies.*" (Paragraphs A4.127 – A4.128, Decision of the Office of Communications, Investigation into BT's residential broadband pricing CW/00613/04/03, 2 November 2010.)

[26] Paragraph 6.139.

[27] *Ibid.*

[28] [CONFIDENTIAL].

[29] [CONFIDENTIAL].

[30] [CONFIDENTIAL].

[31] [CONFIDENTIAL].

[32] Sky estimates that currently around 30% of BT's media spending of over £130 million per annum is devoted to marketing superfast broadband services.

Annex 1

Sky's analysis of the economics of BT's recent offers

A.1 The table below shows Sky's estimate of the profitability and payback period of superfast broadband propositions offered by BT during the consultation period. Apart from costs which are publicly available, such as wholesale line rental charges, BT's costs and revenues are based on Sky's internal estimates.

A.2 This analysis shows that the payback period for these propositions significantly exceeds the 5 year average customer life used by Ofcom in the VULA margin test.

[CONFIDENTIAL]