TalkTalk Group

Fixed Access Market Reviews: Approach to the VULA margin

TalkTalk response

Non-confidential version

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1 Summary

1.1 This document responds to Ofcom's consultation on the manner in which *ex ante* VULA margin squeeze regulation will be put into effect.

1.2 This is a critical piece of regulation. Absent regulation, BT has both the ability and the incentive to margin squeeze its rivals and stifle competition, particularly by raising wholesale VULA prices above cost. We think it is clear that BT has in fact been margin squeezing its downstream competitors. According to a report by WIK, BT's wholesale VULA prices are around double the cost of providing SFBB. Moreover, BT's retail share of VULA connections is persistently high at over 76%, compared to 39% for standard broadband. As such, regulation of margins on SFBB products will be vital to promoting competition over the next 2-3 years, [✂]. Failure to take action against such extension of dominance does not just harm consumers in this market, but does so more generally as it acts as a disincentive to other firms thinking of entering UK telecoms markets.

1.3 TalkTalk broadly agrees with many elements of Ofcom's approach, methodology and assumptions. However, we consider that there are three significant flaws in Ofcom's approach:

- the margin test should be carried out on each SFBB product group separately (at LRIC) in addition to a test of the whole SFBB product portfolio (at LRIC+) as proposed by Ofcom. Ofcom's approach by definition allows BT to retail some products below wholesale charges plus LRIC retail costs, which can never be economically efficient[1] and creates a margin squeeze;
- Ofcom has proposed to use BT's call revenues and not the revenues that a rival could realistically achieve. However, BT has a group of inert legacy customers who generate high call revenues and who are not contestable by rivals. These non-contestable customers should be excluded from the test, since the inclusion of revenue from these customers is inconsistent with the revenue that an efficient competitor could attain;
- the costs of BT Sport should be allocated based on which customers actually take BT Sport (rather than those that are eligible) since this better reflects both the cost caused by each customer (and therefore the long run incremental cost) of BT Sport and the value customers attribute to BT Sport. It also reflects BT's commercial strategy of using BT Sport to drive SFBB uptake, particularly through restricting the ability to access BT Sport on standard broadband. Further, a greater proportion of cost should be allocated to customers who can and do view BT Sport on TV since this also better reflects causality, customer valuations, and BT's commercial strategy.

1.4 The proposed enforcement regime neither has sufficient incentives for BT to comply, nor is it able to identify and remedy breaches (if they occur) quickly enough. To address these weaknesses we propose a number of changes, including greater clarity of how the test is carried out; a more robust and transparent process for testing of

[1] Except in extreme and unusual circumstances

the *ex post* submission BT makes; pre-launch test filing; and, greater clarity around potential fines and other remedies. A regulatory regime in which there is no sanction for breach and a lag in identifying breaches is not effective.

1.5 With these changes to the margin test and the enforcement regime, Ofcom's regulation will have a much greater chance of promoting competition over the medium term.

1.1 Appropriate approach to margin testing

1.6 The assumptions and method that Ofcom adopts in its approach to modelling the *ex ante* margin tests on BT's SFBB products are critical to the efficacy of the regime. The framework which has been set out by Ofcom contains many elements that are appropriate, although TalkTalk believes that there are some changes which would help ensure that Ofcom's objectives to promote competition and avoid competitive distortions are delivered.

1.1.1 Ofcom must assess the margin on each product separately

1.7 Ofcom is currently proposing that the margin test is applied to the whole SFBB portfolio in aggregate (at LRIC+). We think that in addition to this portfolio test, the margin test should be carried out on each product group[2] (at LRIC). Using only a portfolio approach allows three forms of anti-competitive behaviour and welfare harming outcomes.

1.8 First, Ofcom's portfolio approach allows BT to retail some products (of BT's choosing) below wholesale charges plus long run incremental retail costs (LRIC). Such below-cost retail prices are anti-competitive and can never be justified particularly when practiced by a dominant firm that has special responsibility not to allow its conduct to impair undistorted competition. Ofcom has not advanced any pro-competitive or economic efficiency rationale for why pricing below LRIC should be allowed.

1.9 Second, a portfolio approach will result in a margin squeeze of competitors if BT's SFBB customer mix includes inert (and therefore non-contestable) customers who tend to use high-margin products such as Infinity 2[3]. Since competitors cannot access these non-contestable customers, competitors will (even if they offer the full range of products) be subject to a margin squeeze.

1.10 Third, a portfolio test allows BT to act anti-competitively by setting different margins for different products so as to target particular competitors. BT's strategy appears to be to retail some products below LRIC ('entry level' products such as Infinity 1) and some above LRIC ('higher end' products such as Infinity 2). This appears to be part of a strategy aimed at unfairly squeezing its main competitors out of the market.

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[2] TalkTalk would suggest five groups: 1. Infinity 1; 2. Infinity 1 unlimited; 3, Infinity 2; 4. Plusnet Unlimited Fibre; 5. Plusnet Unlimited Fibre Extra.

[3] BT has an incentive to set high margins since these customers are resistant to moving provider. Based on TalkTalk's own analysis [✂].

- [✂]
- BT has simultaneously sought to target Sky through its bundling of BT Sport into SFBB retail products and seeming refusal to wholesale BT Sport on fair and reasonable terms to its competitors.

1.11 As each of BT's main rivals has a distinct customer focus ([✂] at TalkTalk, sport lovers at Sky) and cannot quickly switch to serving other segments, BT is able to target each operators' customers.

1.12 These anti-competitive effects and the economic harm that can result from using only a portfolio test can be prevented by adopting a product-by-product test at LRIC.

1.13 A product-by-product test at LRIC would only be appropriate if Ofcom properly ensured that the LRIC estimate includes all costs that are genuinely incremental (in the long run). We are concerned that Ofcom has categorised too much of BT's overall costs as fixed and common – for instance 25% of the bandwidth cost – leading to an underestimate of the true level of LRIC. If Ofcom is unable to properly determine which costs are incremental then we suggest that the product-by-product test is carried out at LRIC+.

1.1.2 Ofcom's margin test does not reflect the correct revenues

1.14 Ofcom has proposed the use of an 'adjusted EEO' approach to derive revenues and costs. We understand that the intent is to model the revenue and costs for an efficient scale rival to provide BT's product so that BT prices will "*allow 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 prices*"[4].

1.15 However, rather than directly modelling a rival's revenue and costs Ofcom has started with BT's figures and adjusted these. This is a pragmatic approach since for BT to be able to set compliant prices it will need to know what revenues and costs to use, and it will generally only know its own revenues and costs (and not those of its competitors). Ofcom has made two adjustments to BT's revenues and costs:

- a shorter average customer lifetime (ACL) to reflect competitors' ACLs; and,
- putting in place a floor for bandwidth costs, based on the costs incurred by downstream competitors.

1.16 We conceptually agree with Ofcom's use of the adjusted EEO (i.e. to start with BT's costs and make adjustments) but only provided that all the necessary adjustments are made so that the revenues and costs that are tested reflect the revenues/costs that an efficient scale rival would realistically attain. We do not consider that Ofcom has made the necessary and correct adjustments.

1.17 Ofcom is proposing that the test is carried out on BT's out-of-bundle call revenue (and usage) – no adjustment is made to BT's usage/revenue. However, BT has – as a

[4] VULA Margin Consultation §5.11

result of its incumbency – a base of legacy customers who make a very high volume of calls and do not tend to switch providers. Rivals are unable to attract these customers (they are effectively not contestable) and therefore it is wrong to include these customers in a test for the revenues and costs of an efficient rival. The test should focus on customers who are contestable to rivals. If these customers are included in the test then an efficient rival could not "*profitably match BT's retail superfast broadband prices".*

1.18 If Ofcom requires that the margin test is carried out using rival's out-of-bundle call revenue there is a legitimate question of how this can be operationalised in practice. One option might be (like for ACL) for Ofcom to set the actual usage levels (in minutes per month) that BT must use in the test. An alternative, and we think preferable, method would be for BT to conduct the margin test solely based on the usage for BT customers who have been with BT for eight years or less (and therefore have shown that they are willing to switch provider, and as such are contestable). BT could apply this methodology using data in its control, so there can be no issue of BT being unable to assess whether it is complying with its obligations not to margin squeeze. Therefore, we consider that Ofcom should state in its guidance that it will assess the margin squeeze in this way. By using customers who have been with BT for eight years or less Ofcom can also ensure that other differences in customer behaviour – such as use of line rental saver or bandwidth – reflect the customers that a rival can contest.

1.1.3 Ofcom should allocate costs of BT Sport reflecting value to customers

1.19 We agree with Ofcom's approach for determining the cost of BT Sports but disagree with Ofcom's proposal to allocate this cost equally across all broadband customers[5]. As explained below, Ofcom should allocate the cost only to those customers who *take* the service rather than those who are merely *eligible* to have the service and the allocation should also reflect the value attributed by customers to BT Sport.

1.20 Regarding the total cost of BT Sport, TalkTalk has two points:

- First, TalkTalk strongly agrees with Ofcom that it would be inappropriate to exclude the costs of BT Sport within its margin squeeze assessment (or not test triple play bundles at all). We can see no cogent argument as to why the cost of certain features of a product should be excluded from a margin test, particularly given that BT Sport is such a central part of BT's strategy to build its market share in SFBB as repeatedly set out publicly by BT's CEO and senior management.
- Second, Ofcom's proposed approach of setting the costs of BT Sport on the basis that the cost of the current package of FAPL rights are fully recovered over the term of those rights is appropriate. BT appears to be arguing that it is building a standalone profitable sports pay channel and because of this strategy, the rights costs should be amortised over a period considerably

[5] Strictly speaking, Ofcom's approach is broadband customers who can get over 0.5Mbps. However, this encompasses the vast majority of BT customers

longer than the distribution rights, which would remove much of the cost of sports rights from the margin test. This argument is simply not credible:

- this claimed strategy is diametrically opposed to the strategy BT has repeatedly publicly stated (that BT Sports is primarily designed to increase SFBB uptake for BT Retail).
- the current and projected level of rights costs is so high that there is no realistic prospect that a stand-alone sports channel could be profitable for BT.
- amortising the rights cost after the expiry of the rights would only be economically justifiable if there was clear evidence that super-normal profits would be achieved in future or there would be significant exit value (neither of which is likely or plausible).
- there is no evidence to support BT's rhetoric and the approach would be inconsistent with BT's own accounting approach.

1.21 In respect of how net costs are allocated between products/customers, Ofcom has set out two potential approaches:

- the 'Take-up method' which involves apportioning the net costs of BT Sport to different products based on the relative take-up of BT Sport amongst SBB and SFBB subscribers;
- the 'All Broadband Method' which involves apportioning the costs of BT Sport evenly across all customers who take broadband from BT, regardless of whether they access or use BT Sport.

1.22 Ofcom has proposed that the All Broadband method should be used in conducting margin squeeze analyses. This is inappropriate. If Ofcom uses the All Broadband Approach it would fail to reflect the various contractual restrictions which BT has applied (and to some extent continues to apply) to its customers accessing BT Sport, which are designed to push customers into taking SFBB products.

1.23 The Take-Up Method is superior to the All Broadband Method since it is better to allocate the cost to those customers who *take* the service rather than those who are merely *eligible* to have the service:

- first, the customers would be willing to spend more on BT Sports and therefore BT would spend incrementally more on BT Sport (e.g. paying more for sports rights) to satisfy these customers' demand. Thus, these customers *cause* more cost to be incurred (in the long run). If a customer was eligible to get BT Sport but did not take, it then logically BT would not spend any incremental amount on BT Sport (in the long run) to help satisfy this customer – in other words, such a customer (who does not take BT Sport) does not cause any BT Sport cost;
- second, if customers value BT Sport more, then competitors who do not provide BT Sport (like TalkTalk and Sky) will have to offer a greater discount in order to be attractive to customers. For the margin test to protect

competitors from foreclosure the cost allocated to these customers must be increased to reflect their higher valuations.

1.24 The higher value that customers attribute to BT Sport when it is viewed on TV reflected in BT's commercial strategy which has been to encourage SFBB uptake through allowing TV viewing only if customers upgrade to fibre. If there was no added value from viewing BT Sport on TV then such a commercial strategy would be senseless.

1.25 Though the Take-Up Method is superior to the All Broadband Method, it does not distinguish in any way between customers who view BT Sport via a set-top box (and app) and those who view BT Sport only on an app. Customers who can view BT Sport via a set-top box (as well as app) should receive a higher cost allocation than those that only receive it on an app, because they place greater value and gain higher welfare from BT Sport, and therefore cause more cost in the long run.

1.26 We consider that TV products/customers should be allocated about twice as much cost as non-TV customers, reflecting the valuations of different groups of customers obtained from the survey commissioned by TalkTalk. This, combined with the higher access to BT Sport for customers who take SFBB, and the higher propensity for SFBB customers to take TV products, means that between 31% and 58% more of the costs of BT Sport should be attributed per SFBB customer than per SBB customer.

1.27 We think therefore that the appropriate allocation approach is the Take-Up Method but modified to reflect that customer viewing via a set-top box are allocated a greater proportion of the cost – this will appropriately reflect the long run incremental cost that is caused by different customers. It is only by allocating in this way that competition can be properly promoted.

1.1.4 Other assumptions

1.28 In this section we highlight a number of other changes that we think Ofcom should make:

- We agree with Ofcom's approach of using a bandwidth floor though, in addition, [✂];
- We agree with Ofcom's use of an adjustment to the average customer lifetime (ACL) used in determining margins, and setting the ACL at 5 years which reflects the realistic ACL that a competitor could achieve;
- MPF to WLR migrations should be included in the cost since scale competitors (which the adjusted EEO concept should reflect) currently use MPF, whereas Ofcom is assuming that they will provide SFBB bundles using WLR;
- It is not clear whether BT Group overheads have been included in the costs used to calculate the margin test – they should be;

- Ofcom should include termination costs (or charges) for calls that terminate on the BT network since a cost is incurred;
- A number of the cost allocations can be improved to better reflect cost causality; and,
- Ofcom should be wary of using BT's regulatory financial statements (RFS) to determine retail cost levels, since Ofcom itself considers that the RFS13 are inappropriate to set regulated charges because they allocate too much of certain costs to regulated products (and by implication too little to BT Consumer).

1.2 Ensuring compliance

1.29 VULA margin regulation will only be effective in promoting competition if BT's pricing complies with the requirements of the margin test at all times – this will depend on an effective compliance regime. An effective compliance regime should combine both strong incentives for BT to comply and a system that quickly and reliably detects any instances of non-compliance.

1.30 Reflecting these objectives, we think that there are a number of improvements to Ofcom's proposals that will collectively increase the chance that BT will comply with the proposed margin squeeze testing regime.

- Greater clarity of the method and assumptions of the test, and particularly over the precise meaning of the adjusted EEO concept to increase regulatory certainty, reduce the opportunity for BT gaming and to allow higher deterrent fines to be imposed in case of breach;
- Strengthening of the *ex post* testing regime to ensure that breaches are detected correctly and quickly. Such strengthening should include Ofcom quickly reaching pass/fail results which are published and, audit of the data BT provides, to reduce BT's ability to [✂].
- Filing of margin tests for new products before they are launched, to reduce the chance of non-compliant products being offered and to avoid [✂].
- Clarity of fines and what will happen in the case of a breach both in terms of how Ofcom may consider imposing fines and what other remedies might be imposed. This will help create a clear and strong deterrent on BT not to breach and so increase its incentives to comply.

1.3 Structure of this response

1.31 This response is structured as follows:

- section 2 sets out the reasons why it is vital for Ofcom to impose regulation of BT's margins on VULA products;
- section 3 covers the core modelling issues of assessing BT's margins on SFBB products;

- section 4 considers in detail the manner in which the costs of BT Sport should be attributed to SFBB products;
- section 5 sets out the appropriate method for allocating the costs of any bundled mobile products to SFBB products when conducting margin tests; and,
- section 6 deals with enforcement of the margin squeeze regulation.

2 Margin squeeze regulation is vital

2.1 TalkTalk strongly agrees with Ofcom that there is a need for margin squeeze regulation– indeed, such regulation is essential– in the SFBB market. By way of introduction to the remainder of this response, which sets out our detailed commentary on Ofcom's proposed margin squeeze regime, this section provides the market analysis which demonstrates the compelling case for Ofcom to impose margin regulation on SFBB products offered by BT.

2.1 BT has the ability and incentive to engage in a margin squeeze

2.2 It is important to recognise at the outset that BT has both the ability to engage in a margin squeeze against its downstream competitors in the SFBB market, and strong incentives to engage in such a squeeze. Ofcom has explicitly set out that: "*It is our view that BT has the incentive and ability to 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*."[6]

2.3 Notably outside the UK BT has stated that incumbents in a situation akin to that of BT in the UK are likely to use the absence of regulation to margin squeeze. They said of Eircom in Ireland:

> *"Eircom have the both the ability and the motive to foreclose wholesale competition and we believe they will actively pressure competitors in this market. A margin squeeze test is required between regulated access products and end-to-end "white label" wholesale products otherwise the wholesale market will be damaged by squeezing out wholesale competitors."*[7]

2.4 Accordingly below we briefly recap our reasoning for this seemingly non-contentious point.

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[6] Fixed Access Market Reviews: Approach to the VULA margin 19 June 2014 ("**VULA Margin Consultation**") at §3.61

[7] Remedies for Next Generation Access Markets. Response to Consultation and Final Decision. ComReg Document 13/11 31/01/2013 §10.281 http://www.comreg.ie/_fileupload/publications/ComReg1311.pdf

2.1.1 BT has the ability to margin squeeze

2.5 BT's ability to margin squeeze is clear. It is the sole supplier of MPF and of VULA in all areas of the UK (excluding Hull), both of which products BT's two main competitors rely on in order to be able to serve their SFBB customers. [8] At present, BT's Openreach division is the only network offering access products to non-vertically integrated CPs, such as TalkTalk, Sky and EE.

2.6 Although the price of MPF is regulated by Ofcom by means of a price cap, the price of VULA is at present unregulated. The only regulatory strictures on it at present relate to having to offer VULA on non-discriminatory terms (and a loose requirement to price on fair and reasonable terms), and having to publish a price for the product. BT therefore in practice has free choice as to the price which is set for this product, without any constraints from regulation. BT therefore has the ability to set an upstream wholesale price which is in excess of costs, providing one part of the overall margin squeeze.

2.7 BT is also active in the downstream retail SFBB market, and is not subject (at present) to any regulation of the retail price which it charges in this downstream market[9]. It therefore has the ability to set a retail price which is below the total costs of offering SFBB[10], as part of a margin squeeze.

2.8 As such, BT has the ability to margin squeeze, as it has the ability both set an upstream price in excess of costs, and a downstream price below costs.

2.1.2 BT has the incentive to margin squeeze

2.9 BT's incentives to margin squeeze were set out at length at Annex 2 to TalkTalk's response to the 2013 FAMR consultation, dated October 2013. As little has changed since then to alter BT's incentives, this section briefly summarises the points made in that annex, which TalkTalk continues to endorse.

2.10 Given BT's upstream dominance it is able to raise its wholesale price above costs. This has two positive effects for BT. First, it is able to increase upstream profits. The higher price will also be, to some degree, passed through by retail competitors in higher retail prices, which is likely to result in the diversion of retail customers from competitors to BT Consumer and BT Plusnet.[11]

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[8] BT is also the sole supplier of WLR which other BT competitors use. The only major participant in the UK fixed line telecoms market not primarily reliant upon BT is Virgin Media.

[9] BT is subject to an 'equivalence of inputs' obligation which means *inter alia* that its downstream activities 'pay' the same price as external wholesale customers. However, in practice this price is an internal transfer price and does not affect BT's ability or incentives to margin squeeze.

[10] By costs we here mean the wholesale charge levied on downstream CPs, plus downstream operating costs.

[11] If downstream competitors do not attempt to pass on higher wholesale charges this will tend to lessen their incentives to invest (as there will be lower rates of return from doing so), and if there are insufficient supernormal profits may lessen the financial viability of other operators.

2.11 There are few potential costs from BT engaging in a margin squeeze (as set out at §A2.8 of TalkTalk's October 2013 response):

- there is likely to be little loss of volume to Virgin Media from margin squeezing, partly because Virgin's SFBB network at present covers less than 40% of UK households; partly because of product differentiation between Virgin and downstream CPs such as Sky and TalkTalk; and most importantly because [✂]; [12]
- there is likely to be little loss of volume to SBB since SBB is a weak substitute and its substitutability will weaken;
- Openreach increasing its prices will result in little loss of volume (and therefore revenue) since elasticities of demand facing BT Openreach are likely to be low given its monopolist status, intermediaries who will pass on less than 100% of any wholesale price increase, and the quasi-utility characteristics of broadband products.

2.12 The benefits of margin squeezing are likely to far outweigh the potential costs of losses to Virgin and a smaller market scale, and make even the short-run outcome of margin squeezing profitable for BT.

2.13 Moreover, there will be further, long run, benefits from BT engaging in a margin squeeze against its downstream rivals, including:

- the possibility of locking in a dominant position in the retail SFBB market, due to the switching costs present in that market;
- the ability to gain a first mover advantage;
- the possibility of forcing smaller operators (than Sky or TalkTalk) to exit the market altogether due to a lack of profitability;
- [✂].

2.14 Overall, therefore, BT has strong incentives to engage in margin squeeze to go alongside its ability to do so. It should therefore be expected to engage in a squeeze unless regulatory action by Ofcom or the CMA deters or prevents it.

2.2 BT is currently setting a wholesale price in excess of costs

2.15 In principle a margin squeeze could be caused by either excessive wholesale (upstream) prices, insufficiently low retail (downstream) prices, or a combination of the two factors.

2.16 In order to obtain evidence on the underlying explanation of margin squeeze in this case, TalkTalk commissioned the technical consultancy WIK in March 2013 to assess what the appropriate price for BT's GEA products would have been at that point in time. This analysis demonstrated that BT's wholesale prices are far in excess of

[12] [✂].

costs, and that consequently BT would have scope to meet margin squeeze regulation by reducing its wholesale price, rather than by increasing retail prices.

2.17 For this submission, TalkTalk requested WIK to update its analysis in light of evidence that has emerged over the 18 months since WIK's initial analysis was conducted. Accordingly, WIK reviewed and updated the key assumptions for BT's roll-out rate, unit costs and uptake. This analysis continues to demonstrate that BT's prices are well in excess of wholesale costs, and as such BT would be able to significantly cut its wholesale prices without earning a return on capital below its WACC.

2.18 WIK found that the appropriate cost of GEA has fallen in the last year, primarily due to take-up being higher than projected in its earlier assessment. WIK found that the cost per line in 2014 is £4.04 per line, per month. This is far less than the average price, which is around £8.10 at present.[13] In fact the actual prices appear to be in excess of the unconstrained standalone monopoly price, as BT is charging around twice the average cost of providing GEA[14]. It would be profit maximising for BT to price above the unconstrained standalone monopoly price since it is vertically integrated and so benefits from higher GEA prices weakening competition.

2.19 Consequently, there would be a significant reduction in the margin squeeze if BT charged cost-reflective prices for its GEA products. The margin squeeze would be reduced by about £4.00 (i.e. BT is currently charging about double the cost-reflective level). Thus BT can relieve a margin squeeze (up to £4) by reducing wholesale prices, and there would likely be no need for any upwards adjustment to retail prices in order to remove the margin squeeze.

2.20 As such, if BT charged (or had charged) cost-reflective prices for GEA, then on the basis of TalkTalk's numerical analysis (which shows a margin squeeze of about [✂]), the margin squeeze (on the basis that Ofcom has set out) would be [✂]. In other words, the margin squeeze [✂].

2.21 A cost of £4.04 is well below the charge levied by Openreach for any of its VULA products at present, which range from £6.95 to £9.95 per month. BT is therefore setting a wholesale charge well in excess of costs (indeed, it would seem to be close to or above the full unconstrained monopoly price, if BT's weighted average wholesale price is indeed around £8) and would be able to reduce its wholesale charges while earning a return equal to or above its cost of capital.

[13] BT currently charges from £6.90 per month (for 40/2 GEA) to £9.95 per month (for 80/20 GEA). The £8.10 estimate assumes a third of customers are on each of BT Consumer's three main SFBB products (Infinity 1, Infinity 1 Unlimited, and Infinity 2 Unlimited). WIK estimate that the costs per customer do not differ materially between the various products. Thus the different prices for the various GEA products reflect varying levels of supernormal profits for each product

[14] It is a standard economic result that for an unconstrained monopolist facing a linear demand curve and a constant incremental cost, the price set will be twice that incremental cost. As in this instance there are substantial fixed costs of providing GEA (and the average cost is therefore above the incremental cost), the unconstrained monopoly price of providing GEA should be less than twice the average price of provision. We therefore estimate that BT is currently charging above the unconstrained monopoly price for VULA.

2.3 Other considerations

2.22 It may be questioned whether margin squeeze regulation constitutes an unforeseeable change in Ofcom's policy (and therefore violates the principle of regulatory certainty). We do not think such a complaint has any validity. Margin squeeze regulation always has been a legal possibility since before any fibre investment was made. Further, the WLA Market Review in 2010 (which predated most of BT's fibre investment) specifically highlighted that BT's prices would need to pass a margin squeeze test (using an REO concept) to comply with its 'fair and reasonable' obligations.

2.23 BT has suggested that regulation should only be introduced if there is evidence of a margin squeeze, and indeed go further and suggest that BT should not have to provide any data unless a margin squeeze is proven.

2.24 The first point in relation to this is that there is no requirement under the Directives to show harm prior to introducing regulation – instead there is a requirement to show that SMP exists. A requirement to only regulate after there has been consumer harm would subvert the aims of *ex ante* regulation.

2.25 In any case, there is ample evidence of the type of competitive distortions which the regulation is intended to prevent:

- BT have the incentive and ability to margin squeeze;
- it appears that the wholesale price is about twice the cost reflective price;
- BT has over 75% market share; and,
- more tellingly, BT expects (absent regulation) to maintain a high market share (see §3.64).

2.26 BT's argument that there is no problem because TalkTalk's SFBB prices are marginally profitable and below BT's is false:

- the product comparison is not comparing like for like – for example BT's bundles include free BT Sport. Ofcom highlighted this problem in making comparisons[15];
- a margin squeeze test is based on the profitability of a competitor offering BT's products (not the competitor's own products);
- for the market to be undistorted and effectively competitive would require not only that TalkTalk (and other competitors) can offer marginally competitive products but also for them to gain a reasonable market share. This is not the case – TalkTalk has approximately a 22% share of SBB on the Openreach network, but only around 8% in SFBB.

[15] See VULA Margin Consultation §3.80 where it highlights that caution is needed in making such comparison since the retail offerings differ significantly. We also note that at §6.257-§6.259 Ofcom itself seems to make that mistake that it cautions against in comparing different products.

2.27 BT have suggested that the reason TalkTalk has a low share is that our commercial strategy is not to sell SFBB. [✂][16]

2.28 We also think it is worth noting at this point the tactics that BT is adopting in relation to this regulation. Rather than fronting up to the key economic questions it appears to be adopting an approach to prevaricate and delay Ofcom from carrying out its job. For instance:

- It argues that it is necessary to show harm before regulation can be introduced (which will add delay)
- Suggesting that the consultation leading up to any regulation should be broken into sequential steps[17]
- Arguing that BT should only provide data to test compliance if it is proven that BT has not complied[18]

3 Approach to testing margins

3.1 This section sets out TalkTalk's comments regarding the approach which Ofcom proposes to adopt when testing margins, i.e. the method and assumptions Ofcom will use to test whether BT's prices constitute a margin squeeze or not. If Ofcom does not adopt an appropriate approach to determining whether there is, or has been, a margin squeeze, then there is the potential for incorrect conclusions to be reached, in particular a false negative where BT 'passes' the margin test yet there is insufficient available margin to promote competition in the SFBB market.

3.2 This section in particular covers the following issues:

- the choice of a comparator benchmark (in this case proposed as adjusted EEO) when conducting a margin squeeze test under Ofcom's proposed regulation, and how the adjusted EEO should be defined in the present context;
- whether Ofcom should adopt a product-by-product and/or portfolio test to testing BT's margins on SFBB products; and
- the appropriate cost standard (proposed as LRIC+) to test BT's margins against.

3.3 Overall, TalkTalk considers that Ofcom's modelling approach is appropriate in some areas, but significant flaws remain in others. In particular:

- The adjusted EEO approach should reflect the revenues and costs that an efficient competitor is likely to incur. However, Ofcom has not made the appropriate adjustments to BT's costs and revenues to reflect the costs of a competitor. In particular it has used the out-of-package call usage levels of

[16] [✂].
[17] BT Response FAMR Feb 2014 §14
[18] BT Response FAMR Feb 2014 §15

BT, rather than the materially lower usage levels that efficient competitors experience; and,

- there is no valid justification for not conducting product-by-product tests on the basis of at least a LRIC benchmark, as well as testing the SFBB portfolio (in aggregate) at LRIC+.

3.4 The remainder of this section sets out TalkTalk's reasoning for both the areas of its approach in which we support Ofcom's proposals, and those where Ofcom should refine its approach.

3.1 Choice of conceptual approach

3.5 Ofcom sets out three possible conceptual approaches for assessing costs at §5.24 of its consultation document:

- the **EEO (equally efficient operator) approach**. This approach considers whether a downstream competitor operating at the same level of cost efficiency as BT could profitably match BT's SFBB offers;
- the **adjusted EEO approach**. This approach considers whether a downstream competitor with "*slightly higher costs than BT (or some other slight commercial drawback)*" could profitably match BT's SFBB offers;
- the **REO approach**. This considers whether a 'reasonably efficient' operator, could profitably match BT's SFBB offers.

3.6 Ofcom proposes (at §§5.43-5.45) to adopt an adjusted EEO approach when assessing whether there has been a margin squeeze. Ofcom recognises that the adjusted EEO approach can lead to outcomes that are similar to an REO approach, but opines that the adjusted EEO approach has the advantage that it is based on BT's costs, and therefore is simpler for BT and Ofcom to operationalise.

3.1.1 Ofcom is correct to choose the adjusted EEO approach

3.7 Ofcom is right to reject the EEO approach (see §5.54 of the consultation document). Choosing an EEO approach would not fulfil Ofcom's aim of actively promoting competition in the nascent SFBB market (see §5.36 of the consultation document). An EEO approach would not allow a competitor in practice to profitably match BT's offers since they are likely to have revenue and/or cost disadvantages compared to BT. Indeed, an EEO based test would add little to the limited protection already provided to downstream competitors by the Competition Act.

3.8 Both of the other two other options (adjusted EEO and REO) aim to reflect the cost level achievable by downstream competitors. They can in principle result in the same outcome (as Ofcom accepts)[19] if the appropriate adjustments are made to an

[19] See §5.42 bullet 3 and §5.44

EEO's revenues and costs. The main difference in the two approaches is how they are derived in practice:

- in an adjusted EEO approach the revenues/costs of an EEO to the incumbent are first derived based on the costs of the incumbent, then a number of adjustments are made to reflect the costs of a competitor;
- in an REO approach the costs of the competitor are typically directly estimated, without reference to the costs of the dominant incumbent.

3.9 In this context it is important to note that Ofcom appeared to choose the adjusted EEO approach not because it preferred the outcome of using the adjusted EEO approach, but rather principally due to practical considerations (see §5.42 of the consultation document). In particular, Ofcom considered that whilst BT could carry out an adjusted EEO margin test based mainly on its own revenue/cost data, under a 'full REO' approach the costs would need to be derived based on a benchmark REO competitor and forecasts made. Ofcom considered that this would be practically more difficult and would lead to less regulatory certainty for BT.

3.10 In light of this, we have no objections in principle to Ofcom using an adjusted EEO approach provided that the EEO is correctly defined and the appropriate adjustments are made so that the outcome of the adjusted EEO approach is that it allows a competitor in practice to profitably match BT's offers. Such an outcome would be consistent with Ofcom's duties and intent to *promote* competition.

3.11 The reason to prefer the adjusted EEO model is that, like Ofcom, we consider that it is preferable to have an approach that relies predominantly on BT's own revenues/costs. If however, Ofcom does not make all the appropriate adjustments (as described below), then we consider that Ofcom should adopt an REO approach.

3.12 Though we agree in principle with the use of adjusted EEO approach we do have some very significant concerns with how it is specified by Ofcom in this case.

3.13 The European Commission in its recommendation on non-discrimination obligations and costing methodologies[20] addresses margin squeeze testing and describes how such tests should be carried out (it refers to these as testing for 'economic replicability'). It suggests the use of an EEO model though its recommendations allow certain adjustments "… i*n order to ensure that economic replicability is a realistic prospect*"[21] and it has not defined what an EEO is. We consider that an adjusted EEO model is consistent with the Commission's objectives. In any case, a Commission Recommendation does not bind Ofcom, rather they have to take 'utmost account' of it. We consider that Ofcom has sound reason to diverge from the Commission Recommendation and use an adjusted EEO model (if it is indeed different to the Commission's concept) since that is consistent with Ofcom's objective to promote competition and avoid competitive distortions.

[20] Commission Recommendation on consistent non-discrimination obligations and costing methodologies to promote competition and enhance the broadband investment environment (of 11.9.2013)
[21] Ibid Annex II (i)

3.1.2 The adjusted EEO concept needs to be more clearly defined

3.14 Our first concern is that the adjusted EEO approach is not clearly enough defined in light of Ofcom's correct objective to "*clearly [set] out the minimum margin*" (§2.5 of the consultation document) and identify the single approach that is most reasonable (§6.3 of the consultation document). The outcome of an adjusted EEO test depends on both the starting point (the EEO) and what adjustments are made to the EEO benchmark. However, neither of these two stages is well enough defined.

3.15 The EEO concept is often used in competition law. Ofcom has presumed that the EEO revenues and costs are synonymous with BT's revenues and costs – however in some circumstances the revenues and costs of an EEO are not the same as the incumbent's (as Ofcom point out at §4.41 of the consultation document). In fact in this case, we consider that there is a large difference between an EEO's revenues/costs and BT's revenues/costs[22]. In any case, if Ofcom is to use an adjusted EEO concept then it must define what it means by an EEO in this specific case.

3.16 The adjustments that should be made are also not clearly specified. Ofcom's approach to adjustments is encapsulated in its framework for considering what adjustments to make (§6.27 of the consultation document) which is:

- First Consideration – is there evidence that BT's costs/revenues materially differ from those of other operators, and if so, is it likely to be possible for other operators to match BT's costs/revenues?
- Second Consideration – would the adjustment meet our objective by allowing an operator with slightly higher costs than BT (or some other slight commercial drawback relative to BT) to profitably match BT's superfast broadband retail offers?

3.17 However this is an ambiguous statement – for instance:

- it is unclear what type of '*operator*' is being referred to;
- there is no clear definition of '*slightly*' or '*slight*';
- it is unclear what happens in the circumstances where other providers experience (unavoidably) meaningfully higher costs or lower revenues;
- [✂];
- the words 'commercial' and 'drawback' are neither defined nor ones typically found in legal/regulatory documents.

3.18 Such ambiguity is unhelpful and will diminish the effectiveness of the regulation. [✂].

3.19 We think that the clearest and best way of defining the adjusted EEO is to clearly <u>define the end-point</u> or outcome (i.e. the type of operator that the adjusted EEO aims to reflect). The adjustments are then simply the changes that are necessary to convert from BT's revenues and costs (if that is the start point) to the desired end-

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[22] [✂].

point. This is both much clearer and easier to precisely articulate and also avoids a futile and sterile debate about what an EEO is.

3.20 It would be useful if Ofcom precisely defined in one place the nature of what the adjusted EEO concept should reflect. We think that the adjusted EEO test should reflect **whether a scale benchmark competitor could realistically match BT's offers if it were as efficient as BT in controllable aspects**.

3.21 In terms of the various elements of this:

- we say *scale* since it appears Ofcom is not intending that the adjusted EEO reflects the costs of smaller operators, with say, 1% market share[23];
- it is a *benchmark competitor* in that it is not intended to reflect the revenues/costs of a particular operator but a typical (non-BT) scale operator[24];
- we include the condition *realistically* to emphasise that the revenues/costs should be those that a competitor could in achieve in practice, rather some abstract or academic notion of achievable revenues and costs[25];
- the test is to *match* BT's offers since this reflects that the underlying purpose of the test, which is not about the profitability of competitors' own offers but whether competitors could be profitable if they matched BT's offer[26];
- we say *as efficient as BT in controllable aspects* since the costs should reflect BT's level of efficiency but only where a benchmark operator could achieve these. Where BT has a unique revenue or cost advantage that competitors could not realistically replicate then such advantages should be adjusted for[27].

3.22 This definition of what the adjusted EEO approach should reflect is also broadly consistent with the outcome under an REO approach – the key difference between the two methods being whether to start from BT's own revenues/costs or from competitors' revenues/costs. We also note that in the 2010 WLA Market Review Ofcom said that an REO approach was the appropriate test (see §3.5 of the consultation document).

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[23] This is consistent with Ofcom's intent that the market should sustain at least 4 large operators (see VULA Margin Consultation §3.84 and §3.86) or that is scale of TalkTalk or Sky (i.e. around 20% market share)

[24] This is consistent with Ofcom's intent that the object is that a competitor can replicate BT's offer – for example see First Consideration

[25] This is consistent with Ofcom's intent that the object is <u>possible</u> for a competitor can replicate BT's offer – for example see First Consideration

[26] The concept of matching BT's offers is found in many places in the VULA Margin Consultation

[27] This is implicit from, for instance, the adjustments that Ofcom has made to ACL and bandwidth where the aim of the adjustment is to reflect disadvantages that competitors cannot overcome. VULA Margin Consultation §6.236 "*There is evidence that other operators are likely to have a materially shorter ACL than BT. Given the persistent nature of the difference between BT and [✂], this suggests that it is difficult for other operators to close the gap in ACLs by making changes to their respective commercial strategies.*"

3.2 Adjustments that need to be made to BT's revenues/costs

3.23 Our second area of concern with Ofcom's approach is that we think that Ofcom has omitted to make a number of adjustments to BT's revenues and costs[28] to ensure that the proposed margin test allows an efficient scale operator to match BT's offer.

3.24 Competitors will be disadvantaged versus BT, particularly as a result of BT's historical dominance of the retail market (i.e. legacy incumbency). Ofcom has made two adjustments to reflect this disadvantage:

- the adjustment to ACL to reflect that competitors have lower customer lifetimes (5 years) than BT achieves (7 years) in part due to BT's legacy incumbency[29];
- the adjustment to BT's bandwidth costs (in practice a floor) is made since Ofcom considered that competitors could not replicate BT's cost[30].

3.25 However, we think that there are other disadvantages resulting from BT's incumbency and vertical integration that should also be included.

3.26 The most significant of the missing adjustments is whether BT's usage levels should be used in the margin test (or conversely an adjustment should be made). This is discussed in section 3.2.2 below.

3.27 We think there are other adjustments that should be made including to adjust for different usage characteristics, non-replicable scope economies and the free advertising (heavily focussed on fibre) that Openreach provides for it. These are discussed in section 3.2.4 below.

3.2.1 Ofcom has not correctly applied the adjusted EEO approach

3.28 As we explain above the main adjustment to BT's costs that should be made it to out-of-package call usage /revenue. In this section we explain why it is justified, the evidence that supports that there is a significant usage difference and how the adjustment to BT's cost can be implemented in practice.

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[28] If Ofcom continue to use BT's revenues/costs as its starting point then it is not is not correct to talk about adjustments to EEO revenues/costs but rather adjustments to BT revenues/costs. In any case, when we talk about an adjustment to BT's revenue/costs it is academic as to whether such adjustment is part of the EEO or not

[29] VULA Margin Consultation §6.235 "*BT's longer ACL could be a consequence of its position as the legacy incumbent. Customers that are reluctant to switch may be more likely to remain with BT (as the incumbent telecoms network operator) whereas customers of other CPs are likely to have switched at least once (to move away from BT).*"

[30] VULA Margin Consultation §6.28 "*we consider that it is possible that BT could have advantages with respect to unit bandwidth costs that would be difficult for other operators to replicate due to BT's larger scale in the supply of non-broadband bandwidth dependent services.*"

3.2.1.1 Unique features of the SFBB market

3.29 As explained above the outcome of the adjusted EEO margin test should reflect the revenues/costs that a competitor could realistically achieve. The features of the SFBB market mean that there is a significant difference between BT's call revenue and that competitors could realistically achieve (if they replicated BT's product). This is for a number of reasons that will be familiar to Ofcom:

- consumers are locked in to their providers (condition 1). In most consumer markets, consumers and their suppliers do not enter into long-term supply contracts. Rather, for most goods there is a single point of sale, which does not imply any commitment to purchase again from that supplier. However, in the SFBB market there are minimum contract terms (generally 18 months in duration) during which consumers cannot switch provider; and, even when a customer is out of contract, there are substantial switching costs for consumers, including perceived and actual hassle, the need for new routers, a new minimum contract term, and in many cases cash "activation fee" payments to providers. As such, customers are only likely to switch provider when they see a clear advantage to doing so, which means that only about 15% to 20% of customers switch provider per year.
- there is a long-term incumbent, which has both a strong brand and a base of customers who have never switched provider, but have merely switched between different products from the same provider (condition 2). In the SFBB market, BT is this incumbent, and was until relatively recently dominant in the downstream retail market as well as in upstream markets. Ofcom discusses this at §6.235 of its consultation document.
- pricing is based on a multi-part tariff, with a monthly rental charge and usage charges (condition 3). Again, this is unusual, as most markets have either a monthly rental charge without any usage tariff (for example, gym subscriptions or property rental) or have no subscription but payment at the point of sale (groceries, hairdressing services). Such a multi-part tariff implies that customers taking the same product and paying the same prices (for an SFBB bundle in this case) can have very different levels of observed revenue and profitability because they have different usage levels.
- customers who have never switched provider have identifiable behavioural and usage differences from other customers who have switched provider, and in particular yield higher average call usage/revenue (and therefore margin) for a given price level (condition 4).

3.30 The cumulative impact of these criteria is to provide BT with a revenue/ margin advantage which is not replicable by competitors. Due to conditions (1) and (2), BT has a customer base which will not be able to be attracted by other operators, even if they offer prices below BT's. By conditions (2), (3) and (4) any higher average revenues accruing to BT need not be a result of BT being in any sense more efficient than its competitors, for example by operating more productively, but rather are due to its legacy customer base.

3.31 In such a situation, an operator will be unable to match BT's revenues (and therefore margins) if they price at the same levels as BT. This has the effect that even if such a competitor is as efficient as BT in all controllable aspects, it will be unable to make a profit by setting the same prices as BT. Therefore, as an efficient operator would not be able to compete effectively if it had the same downstream costs as BT, Ofcom runs the risk that even its *adjusted* EEO measure would not allow an efficient operator to compete in the SFBB market.[31]

3.32 It appears that Ofcom supports the concept of carrying out the margin test based on contestable customers. When discussing the allocation of the costs of BT Sport between SBB and SFBB customers, Ofcom states at §6.160 that:

> *when BT's rivals are seeking to win new fibre customers they are unlikely to just focus on competing for BT's existing fibre base. They will also consider upgrading their own copper broadband subscribers, upgrading copper broadband subscribers served by other operators and acquiring fibre customers from operators other than BT. In other words... the Take-Up Method... may not be the group of consumers that rival operators are particularly seeking to acquire.*

3.33 In terms, Ofcom is highlighting that the margin test should be carried on customers that competitors compete for and not (in this case) just BT's existing SFBB customers. We agree.

3.34 Ofcom has therefore erred by not at least adjusting BT's revenues to reflect the revenues (and therefore margins) that would be able to be obtained, at the same prices as BT, by an operator which did not benefit from BT's incumbent status.

3.2.2 Revenue differences are due to BT's customer base having higher usage

3.35 As explained above, the (adjusted) EEO revenues used in the margin test should reflect the revenues of the contestable cohort of customers i.e. those customers who are not inert and have switched operators. Therefore, if the revenues of contestable cohort are different to BT's then there should an adjustment to BT's revenues to reflect this.

3.36 At §6.44A of its consultation document, Ofcom sets out that TalkTalk (which reflects the revenues of contestable customers) has (as of mid-2014) lower average out-of-package call revenues than BT. Ofcom provides a number of potential reasons for this difference:

- BT could be setting higher tariffs for its out-of-bundle calls;
- BT could be including fewer calls in its SFBB bundles; or,
- BT's customers could have a higher out-of-package call usage.

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[31] TalkTalk understands that the only change made as a result of a move from an EEO to an adjusted EEO benchmark is to change the average customer lifetime, and that this change represents about £1-£2 per customer month of required margin (see Table 6.9 of the consultation paper). At the same time, we estimate [✂].

3.37 It can immediately be seen that the last of these potential reasons is analogous to condition 4 at §3.29, above. If this is the reason for the revenue difference, then Ofcom should adjust BT's customer call revenue used in its adjusted EEO test. The other two potential reasons given by Ofcom for BT's higher call revenues would not necessarily require an adjustment to BT's revenues since the adjusted EEO margin test is based on BT's pricing and BT's bundling structure. However, these two reasons can quickly be ruled out.

3.38 The first of these is that BT could be achieving higher revenues since its tariffs for out-of-bundle calls are higher than TalkTalk's. Table 3.1 below sets out BT's and TalkTalk's charges for different types of out-of-bundle calls for customers without any additional bolt-ons of bundled calls (such as TalkTalk's Anytime UK Calls boost, or BT's Unlimited Anytime Calls). Both BT and TalkTalk charge a 15p connection fee for all calls.

Table 3.1: Comparison of BT and TalkTalk call pricing

Type of call	Time of day	BT price per min	TT price per min
UK landline	Daytime	9	11.5
UK landline	Evening	9	11.5
UK landline	Weekend	9	11.5
UK mobile	Daytime	12	11.5
UK mobile	Evening	12	11.5
UK mobile	Weekend	12	11.5

3.39 As can be seen, BT's pricing is well below that of TalkTalk on calls to UK landlines, while being approximately the same for calls to UK mobile telephones. This points towards higher BT prices not being the explanation of meaningfully higher call revenues for BT than for TalkTalk. As such, this potential reason is demonstrably not the case.

3.40 The second potential reason for BT experiencing higher out-of-bundle call revenues than TalkTalk is that BT could be including fewer calls in its SFBB bundles than TalkTalk. In fact, TalkTalk offers packages with fewer bundled calls than BT's SFBB packages, as shown in Table 3.2.

Table 3.2: Comparison of calls included in package

		Weekend?	Evening?	Daytime?	Mobile?
Simply Broadband	TalkTalk	✗	✗	✗	✗
Essentials TV	TalkTalk	✓	✓	✗	✗
Plus TV	TalkTalk	✓	✓	✓	✗
Infinity 1	BT	✓	✗	✗	✗
Infinity 1 Unlimited	BT	✓	✗	✗	✗
Infinity 2 Unlimited	BT	✓	✗	✗	✗

3.41 That BT's customers have higher usage levels than TalkTalk is clearly demonstrated by the out-of-package revenue of TalkTalk's Simply Broadband SFBB customers. We estimate that BT's out-of-package call revenue is [✂][32]. From Feb 2014 to July 2014

[32] [✂].

the average out-of-package call revenue of TalkTalk's Simply Broadband SFBB customers averaged [✂]. Given the prices for out-of-package calls are the same, and more of these customers' usage is out-of-package than for BT's SFBB customers,[33] the only plausible explanation for BT's higher out-of-package call revenues must be that BT customers have significantly higher usage.

3.42 Ofcom should therefore not be using BT's call revenue data when conducting its margin squeeze test and should be making adjustments to reflect the lower usage that a competitor would enjoy. Ofcom has not set out in its consultation document any reason for not doing so, and in fact has not addressed potential adjustments to revenue under the adjusted EEO standard at all.

3.2.3 It is practical to adjust BT's revenues

3.43 Ofcom, quite properly, has a concern that BT should be able to conduct the margin analysis itself without access to the commercially sensitive data of its downstream competitors. Therefore, if the usage levels of a competitor are to be adopted, Ofcom needs to be able to ensure that BT knows what these are so that it can set compliant wholesale and retail prices.

3.44 One way that competitors' usage could be implemented could be for Ofcom to specify in guidance or an SMP Condition the level of usage of a benchmark competitor that BT should adopt in the compliance test (in minutes per month by call type) – as it has done for average customer lifetime and the bandwidth cost floor. Ofcom would also need to forecast usage levels over the whole review period – this is likely to be difficult and raises the risk of regulatory error. Ofcom discusses this at §5.42 bullet 2.

3.45 There is an alternative approach available that does not require Ofcom to provide usage forecasts but rather is based solely on data that BT has access to.

3.46 This alternative approach would be for BT to determine average call revenues only by considering customers who have been with BT for eight years or less and take SFBB[34] – we refer to this group of customers as the 'contestable cohort'. Calculating call revenues in this way would remove the impact of inert legacy customers who are not accessible to other providers. Rather, it would focus on accounts which could be attracted by different operators.

3.47 This method would be robust. If BT's inert customers genuinely have similar usage characteristics to active, switching customers, then the out-of-package call revenues observed by the two groups will be similar. It is only if there is a systematic difference between call usage in customers who switch operators, relative to the call usage of customers who are inert BT customers, that BT will have to use different

[33] As shown above for Simply Broadband all calls are out-of-package whereas for BT SFBB packages only evening and daytime calls are out-of-package.
[34] Eight years is the period of time for which TalkTalk considers competition has been active in the broadband market. Customers who have been with BT for more than eight years are likely only ever to have taken broadband from BT, and will likely be completely disengaged from the market.

call revenues in margin testing than would be derived from an approach based on averaging across all customers.

3.48 Such an approach should not lead to any uncertainty or lack of legal predictability for BT. BT has all of the data required to implement this methodology (for instance, the date of a customer joining BT should be readily available to BT). It does not need to rely upon any data from its competitors, and can replicate the approach in the ongoing margin testing that it should be undertaking for compliance purposes.

3.49 Such an approach will also require there to be adjustments to BT's interconnection and call transiting costs in order to reflect changes to call volumes. This could be simply accomplished by applying the interconnection cost for all customers on a pence per minute basis (or as a percentage of revenue) to the usage/revenue for the contestable cohort.

3.2.4 Other adjustments to BT's revenues and costs

3.50 We consider that there are a number of other adjustments that should be made (provided that they are material). The key ones are:

- other differences in usage characteristics e.g. the proportion of customers taking up line rental saver, bandwidth used or PPV movies watched. This could be corrected for by using a similar type of 'contestable cohort' analysis as described above where the test is based on customers who have been with BT for eight years or less;
- package mix. [✂]. This could be addressed using the 'contestable cohort' analysis set out above. Alternatively, if product group tests were carried out at LRIC+ there would be no need to make this correction;
- economies of scope. We think that Ofcom should adjust for any economies of scope between Openreach and BT Consumer/Plusnet since it is not possible for a competitor to replicate Openreach. Though BT Global Services is also unique to BT we do not consider this should be adjusted for since it is arguably possible for competitors to replicate this business;
- economies of scale. If fixed costs are small [✂] then there will be small economies of scale; we do not think that these need to be corrected for. However, if for instance Ofcom argues that 25% of the bandwidth cost is fixed and common it implies that here are material scale economies. Adjustments should be made to reflect any such material economies of scale;
- BT Consumer benefits from free advertising on Openreach property particularly 40,000+ cabinets and 15,000 vans since the Openreach logo says 'Openreach … a BT Group business' with a large BT globe. This promotes and benefits BT Consumer and particularly fibre since the cabinet advertising is normally focussed on fibre (e.g. it says "*fibre broadband is here*"). In the context of determining an adjusted EEO's revenues and costs this free advertising is not replicable by competitors and thus should be adjusted for. Neither the benefit to Openreach (or lack of it) from the advertising nor the

(low) cost of Openreach including the BT Group logo is relevant to the question of the correct adjustment to the EEO.

3.3 Appropriate cost standard

3.51 Ofcom discusses the appropriate cost benchmark for margin squeeze testing at §5.46-5.65 of its consultation document.

3.52 In principle, there are two main cost standards that Ofcom could choose when assessing whether BT has engaged in a margin squeeze on SFBB products:

- testing on the basis of long run incremental costs (**LRIC**);
- testing on the basis of **LRIC+** which is LRIC costs plus a contribution towards common costs. Meeting a LRIC+ cost standard inevitably requires a higher margin to be set than where a LRIC cost standard is used.

3.3.1 Ofcom is correct to use LRIC+ as its core cost standard

3.53 Ofcom sets out at §5.64 that it intends to use LRIC+ as the cost standard which BT's pricing of SFBB products must meet. BT's SFBB products must therefore cover their own incremental costs, while also making a contribution towards BT's common costs.

3.54 Ofcom proposed the use of LRIC+ as the cost standard for the margin test. By testing at LRIC+, Ofcom can better replicate the competitive conditions facing efficient downstream rivals to BT. BT's downstream rivals have no choice but to recover an allocation of common costs from SFBB products. If competitors do not do so, then as SFBB grows as a proportion of our overall broadband customer base, competitors will either be forced to increase prices on SBB products (risking losing volumes in the SBB market, particularly since customers left in this market are likely to be disproportionately poorer, more value-oriented customers with higher price sensitivity) or to accept that our overall broadband base will be unable to support its share of common costs. Given that consumer broadband bundles represent well over half of TalkTalk's revenue, this would not be a sustainable situation.

3.55 As such, Ofcom's test should ensure that BT's SFBB portfolio as a whole is priced in a way that enables BT's competitors to recover both the incremental costs of selling SFBB products, and an appropriate apportionment of common costs. This will allow BT Consumer and its downstream competitors such as TalkTalk, Sky and EE to compete on an equal playing field.

3.56 BT argued (see §5.63 of the consultation document) that using LRIC+ will not allow it to encourage migration from copper to fibre (since it cannot reduce fibre prices and increase copper prices by recovering more common cost from copper products). This argument is weak. The principal benefits of migration come at the network level. Therefore, if BT wish to encourage migration it is appropriate that they alter VULA prices.

3.57 Although the core cost standard to use is LRIC+, there is a particular role for LRIC based testing (of product groups). We explain this below.

3.4 Product-by-product versus portfolio testing

3.58 In conducting margin squeeze tests on VULA products, it is important to choose the correct groups of products to test against. Either choosing too wide a set of products, or too narrow a set, can lead to the margin testing regime becoming ineffective, and failing to prevent the occurrence of margin squeeze and the harmful effects to competition and consumers that margin squeezes cause.

3.59 Using a portfolio approach only (i.e. a broad set) allows for three potential anti-competitive and welfare harming outcomes.

3.60 First, a portfolio approach allows BT to retail some products (of BT's choosing) below wholesale charges plus long run incremental retail costs (LRIC). Such below-cost retail prices are anti-competitive and can never be justified particularly when practiced by a dominant firm that has special responsibility not to allow its conduct to impair undistorted competition. Ofcom has not advanced any pro-competitive or economic efficiency rationale for why pricing below LRIC should be allowed[35].

3.61 There is no rational justification for BT wishing to price any individual SFBB product group at below LRIC. Doing so would ensure that BT makes an incremental loss on the sale– i.e., there is a negative contribution towards common costs. Such a pricing policy will distort competition (by setting a price below the competitive price level, ensuring excessive demand for the product priced below LRIC, and inefficiently low demand for other products, particularly those which are the closest substitutes). It will therefore reduce total welfare in the economy compared to a situation where no product is priced below LRIC. In the same way, it cannot be justified on second best or Ramsey pricing grounds, as Ramsey prices cannot be below LRIC. Finally, there are no obvious externalities arising from retail customers taking SFBB rather than SBB which would make it welfare-enhancing to price below LRIC.[36]

3.62 Second, a portfolio approach will result in a margin squeeze of competitors if BT's SFBB customer mix includes inert (and therefore non-contestable) customers who tend to use high-margin products such as Infinity 2[37]. Since competitors cannot

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[35] There can be no question of BT needing to be able to price below LRIC in order to have flexibility to recover common costs efficiently since sub-LRIC pricing infers that negative amounts of common costs will be recovered from certain products (which is not efficient)

[36] Note that it is not sufficient to point to there being externalities from consumers taking broadband (regardless of the speed). If that were the case, then it would be most welfare-enhancing to set a price below LRIC for the lowest speed broadband products, as those would then be the lowest price, and most likely to bring in marginal customers who at present do not have internet access. It would require an implausible set of consumer preferences for consumers to prefer SFBB to no broadband, but to prefer no broadband to SBB, when both SFBB and SBB are priced at LRIC.

[37] BT has an incentive to set high margins since these customers are resistant to moving provider. [✂].

access these non-contestable customers, competitors will (even if they offer the full range of products) be subject to a margin squeeze.

3.63 Third, a portfolio test allows BT to act anti-competitively by setting different margins for different products in order to target particular competitors – such as those with more limited financial resources. BT's strategy appears to be to retail some products below LRIC ('entry level' products such as Infinity 1) and some above LRIC ('higher end' products such as Infinity 2). This appears to be part of a strategy aimed at unfairly squeezing its main competitors out of the market.

- [✂]
- BT has simultaneously sought to target Sky through its bundling of BT Sport into SFBB retail products and seeming refusal to wholesale BT Sport on fair and reasonable terms to its competitors.

3.64 As each of BT's main rivals has a distinct customer focus ([✂] at TalkTalk, sport lovers at Sky) and cannot quickly switch to serving other segments, BT is able to target each operators' customers.

3.65 On the other hand, if too narrow a set of products is chosen, then there will be a need for a very large number of tests to be undertaken, increasing the burden both on BT of testing its products, and on Ofcom in assessing BT's compliance with the margin squeeze regulation. Another small downside of narrow tests (but only if they are carried out at LRIC+) is that it removes BT's flexibility as to how it recovers genuinely common costs.

3.66 As such, it is important for Ofcom to strike an appropriate balance between narrow and wide testing of products, to ensure that BT is neither able to harm consumers (by pricing below LRIC, targeting individual competitors, or exploiting its inert customers) nor is there an excessive regulatory burden, but that costs are covered across SFBB products taken as a whole.

3.67 There are a number of different levels at which Ofcom could undertake its margin test, as set out at §5.95 of Ofcom's consultation document:

- the **total broadband approach**, which would involve assessing the profitability of bundles containing SBB or SFBB in aggregate;
- the **total fibre portfolio approach**, which would involve assessing the entire portfolio of bundles that use VULA as an input;
- the **fibre product group approach**, which would involve assessment of categorised groups of SFBB bundles offered by BT;
- the **individual product approach**, which would involve assessing the individual bundles offered to consumers.

3.68 Ofcom summarises its approach to the aggregation of products that it plans to test at §5.114:

> *Our provisional conclusion is that the most appropriate output increment is BT's fibre portfolio. Such an approach would provide BT with additional flexibility (or*

put another way, avoids the need to specify how common costs should be allocated between particular fibre products or groups of fibre products). Allowing such flexibility is desirable...

3.69 Ofcom therefore rejects using the total broadband approach, the fibre group approach and the individual product approach in its proposals.

3.4.1 Ofcom is right to reject the total broadband approach and the individual product approach

3.70 Ofcom is correct in its rejection of both the total broadband approach and the individual product approach.

3.71 Adoption of the total broadband approach would involve assessing the market too broadly. Whereas the market for SBB appears at present to be broadly competitive (with no operator holding a market share of more than one third of the market) the same is not true of the SFBB market.

3.72 In its results dated 31 July 2014, BT set out the share that BT Consumer holds of SFBB connections over the BT Openreach network. BT set out that it had a retail customer base of around 2.3m customers taking SFBB, out of around 3m SFBB lines over the Openreach network– that is, BT Consumer had an on-net market share of around 76%. This is clearly very different from BT's on-net market share in broadband as a whole (which would be considered under the total broadband approach), which was around 39% at the end of March 2014.[38] That is, BT has an on-net market share in SFBB around twice as high as in broadband as a whole. It is this disparity which creates a need for Ofcom to take specific measures to address the SFBB market.

3.73 As such, Ofcom's analysis at §§5.100-5.102 of the consultation document is entirely appropriate. The purpose of the regulation is to avoid distortion of competition in provision of products using VULA. It makes no logical sense to create a margin test that includes products from another market whether SBB or leased lines. Doing so would indeed run the risk of margin squeeze regulation being circumvented, and prices for SFBB products as a whole being set either with no contribution to common costs, or indeed at below LRIC. A narrower cost standard is necessary if there is to be effective regulation of SFBB margins.

3.74 Ofcom is also correct to reject the individual product approach. Given the range of bundles provided by BT, conducting a margin test on each possible bundle would potentially require many hundreds of tests to be undertaken, creating a significant regulatory burden on both BT and on Ofcom.

3.75 TalkTalk also agrees with Ofcom's point that it would risk regulatory error to attempt to regulate the margin on every single individual SFBB product combination offered by BT Consumer. Therefore, although individual product testing would be the

[38] Source: Enders' Analysis data

strongest protection against a margin squeeze its benefits are likely to be less than its costs.

3.4.2 A total fibre portfolio test at LRIC+ is appropriate if complemented by a product group test

3.76 Ofcom has proposed that it should use the fibre portfolio approach, with tests undertaken on a LRIC+ basis for allocation of costs. TalkTalk considers that this is one element of a reasonable approach to adopt. Frontier also discuss this issue in sections 3 and 4 of their report annexed to this document.

3.77 We think that the portfolio test (at LRIC+) should be complemented by a product group test at LRIC. The combination of the two will:

- allow competitors to recover a suitable proportion of their common costs from SFBB products as explained above at §3.54. [✂];
- allow BT full flexibility as to how it recovers genuinely common costs from different SFBB products;
- prevent harmful (below LRIC) pricing that is allocatively inefficient and could be used to target particular competitors;
- removes any non-replicable advantage BT enjoys from its inert customers who consume proportionately more high end (and high margin) products;
- by testing at a product group level (we suggest five groups) the regulatory burden will be limited. BT will already have to maintain a margin squeeze model, both for the purposes of complying with the Competition Act's strictures on dominant firms, and in order to undertake tests at a portfolio level.

3.78 A product-by-product test is necessary, as set out by Frontier. We think that it could be conducted using LRIC but this would only be appropriate if Ofcom ensured that the LRIC estimate includes all costs that are genuinely incremental (in the long run). We are concerned that Ofcom has categorised too much of BT's overall costs as fixed and common – for instance, we understand that Ofcom assumes that 25% of the bandwidth cost is fixed and common; Ofcom appears to suggest that all BT Group overhead costs are fixed and common (§6.101). This will lead to an underestimate of the true level of LRIC.

- An assumption of 25% of bandwidth costs being fixed is implausible. It would mean that EE would have a bandwidth cost per customer more than twice as high as BT, and that small operators' bandwidth costs would be well in excess of their revenues.[39] We consider that in the long run the vast majority (and far more than 75%) of the bandwidth cost is variable

[39] EE has a market share in fixed line telephony of 3%; BT has a market share of around 30%. A quarter of BT's bandwidth costs being fixed would imply that an operator with a market share at or below 7.5% would have an entirely fixed cost base. This means that EE's (entirely fixed) bandwidth cost per customer would be approximately two-and-a-half times higher than BT.

- Though BT Group overhead costs are joint costs they are not fixed and common since they vary in respect of volumes. BT itself in its RFS[40] says that up to 100% of these costs are variable.

3.79 Ofcom's approach will lead to an underestimate of the true level of LRIC and so a product-by-product test at LRIC will not prevent sub-LRIC pricing.

3.80 If Ofcom is unable to properly determine which costs are incremental then we suggest that the product-by-product test is carried out at LRIC+.

3.81 We do not think that the disadvantages of product-by-product testing at LRIC+ are that significant – the only meaningful disadvantage is the loss of flexibility as to how common costs are recovered between (but not within) product groups. It appears that the common costs are likely to be about £2 per customer month. This is small compared to the BT's average SFBB price / revenue which is about £35-40 per month. Ofcom has not explained what benefit price flexibility would provide to customers (as against benefit to BT). Therefore, any additional efficiency that the flexibility would allow would be small.   Furthermore, BT has significant flexibility to adjust VULA prices (since most of the cost is common) if it wishes to, say, stimulate demand.

3.82 TalkTalk's proposals regarding tests (portfolio at LRIC+ and product groups at LRIC) is consistent with, or if anything less stringent than what is suggested in the European Commission's recommendation[41] which suggests individual testing of 'flagship' products at LRIC+. For instance the Commission says

NRAs should assess the most relevant retail products including broadband services ('flagship products') offered by the SMP operator[42]

The NRA need not run the test for each and every new retail offer but only in relation to flagship products to be identified by the NRA[43]

In order to exclude cross- subsidisation between different products in a bundle or portfolio, NRAs should conduct only a single-level test, i.e. between the retail services and the most relevant NGA access input for the access seekers (for example fibre access at the cabinet, virtual unbundling). [44]

The economic replicability test set out by the NRA in advance should be adequately detailed and should include as a minimum a set of relevant parameters in order to ensure

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[40] Regarding certain BT Group costs (including: Management consultancy, AGM costs, Crown Estates legal fees, Employee shareholding, audit fees (including statutory accounts), royalties, production and filing of Securities reports, shareholders registration) BT say that 0% of the costs are fixed. See page 91 Long Run Incremental Cost Model: Relationships & Parameters 31 July 2013 http://www.btplc.com/Thegroup/RegulatoryandPublicaffairs/Financialstatements/2013/LRIC1.pdf

[41] Commission Recommendation on consistent non-discrimination obligations and costing methodologies to promote competition and enhance the broadband investment environment (of 11.9.2013)

[42] Ibid Annex II (iv)

[43] Ibid Recital 66

[44] Ibid Recital 67

predictability and the necessary transparency for operators. NRAs should apply a LRIC+ model[45]

Relevant cost standard. The incremental cost of providing the relevant downstream service is the appropriate standard. A LRIC+ model should be used to calculate the incremental cost (including sunk costs) and to add a mark-up for common costs related to the downstream activities. [46]

3.83 Ofcom accepts (at §7.36) that the recommendation suggests a product-by-product test.

3.84 It is also notable that BT (outside of the UK) considers that product by product test are appropriate. They said of margin squeeze regulation in Ireland:

"BT and E-net generally agree but both of them are of the view that a product by product approach is preferred over a portfolio approach."[47]

3.4.3 Definition of product groups

3.85 As set out in TalkTalk's submission dated October 2013, at §A5.18, we suggested that there should be six product groups: one for each of BT's core SFBB products (Infinity 1, Infinity 1 Unlimited, Infinity 2 Unlimited) with and without TV.

3.86 However, in light of a number of developments and also more consideration on our part we think a slightly different approach should be taken. This comprises:

- Two portfolio tests at LRIC+ –one for BT Consumer and one for Plusnet
- Five product group tests at LRIC

3.87 We explain our rationale below.

3.4.4 Separate portfolio tests should be undertaken at LRIC+ for Plusnet and BT Consumer

3.88 In its current proposals, Ofcom envisages that products offered under BT's Plusnet brand will be considered as part of the same LRIC+ portfolio level test as products provided by BT Consumer (see §A6.8). There is, at present, no proposal to test any Plusnet product, or Plusnet products as a whole, separately.

3.89 This is not appropriate. BT Plusnet's products should be tested separately from BT Retail (at both a LRIC+ Plusnet portfolio level, and an individual product group level against LRIC).

[45] Ibid Recital 67
[46] Ibid Annex II (ii)
[47] Remedies for Next Generation Access Markets. Response to Consultation and Final Decision. ComReg Document 13/11 31/01/2013 §10.358
http://www.comreg.ie/_fileupload/publications/ComReg1311.pdf

3.90 It is important to recognise that Plusnet operates separately from BT – for instance: it operates as a 'fighting brand' and its target customers are different; it offers very different packages that do not include (for instance) BT Sport; its brand and advertising does not mention that it is owned by BT; and, its operations are separate. As a consequence of this we believe that there are few costs that are truly common as between Plusnet and BT Consumer. If this is the case then margin testing (at LRIC+) the Plusnet SFBB portfolio separately from the BT Consumer SFBB portfolio will not diminish BT's flexibility to recover common costs.

3.91 As such, BT Plusnet's fibre portfolio should be tested against a LRIC+ benchmark, based on the incremental and common costs of the Plusnet division. Individual BT Plusnet product groups should be tested against a LRIC benchmark.

3.4.5 Five product groups

3.92 Since TalkTalk's earlier submission BT has simplified the pricing of its TV product, and there may now be scope for a product group to encompass a core SFBB package with and without TV.

3.93 Recognising this and the appropriateness of Plusnet being tested separately we see that there should be five product groups

- Infinity 1
- Infinity 1 unlimited
- Infinity 2
- PlusNet Unlimited Fibre
- PlusNet Unlimited Fibre Extra

3.4.6 Conclusion on testing

3.94 The appropriate approach to be taken to the testing of products by Ofcom is as follows:

- a test across the whole SFBB portfolio should be undertaken on a LRIC+ cost basis, to reflect the need that BT's downstream competitors have to be able to recover a proportion of their common costs from SFBB products;
- Plusnet should be considered in a separate portfolio test (at LRIC+) from BT Retail.
- Each of five individual product groups should be tested on a LRIC basis, to prevent BT from pricing any product very aggressively, and so targeting its individual downstream competitors with exclusionary behaviour; and,

4 BT Sport

4.1 One of the critical issues in a well-designed margin squeeze testing regime is to take the costs of BT Sport into account in an appropriate manner. BT Consumer has made a very large investment in BT Sport – likely in excess of £500m per year – and is primarily seeking to recover those expenses through selling more fibre broadband.

4.2 In this section we explain our view on how the costs of BT Sport should be taken into account in the margin test. We first consider what costs should be included and second how this cost should be allocated amongst different products.

4.1 BT Sport must be taken into account in testing margins

4.3 When testing products' margins, it is vital that all of the bundles and all of the costs of those bundles are properly taken into account. If some of the costs of particular bundles are not taken into account, then it opens the way for BT to subvert the regulation through gaming – for instance, if the costs of a particular (costly to provide) feature were not included in the margin test (which would otherwise have increased the necessary margin) BT would be incentivised to introduce such features in order to margin squeeze its competitors. Accordingly, we agree with Ofcom's reasoning (see §5.83 of the consultation document) and proposals that all bundles that rely on VULA (including triple play ones) should be tested. We also agree with Ofcom's proposal to use a net cost approach to derive the relevant costs of BT Sport, with the net cost calculated assuming that the costs of sports rights are expensed over the period when BT has the distribution rights[48].

4.4 BT has argued that bundles including sports content (that is, those including BT Sport) should not be tested and/or that a much lower proportion (or none) of the costs of sports rights should be included in the margin test. BT has put forward two arguments in favour of this approach.

4.5 Initially BT argued (in its FAMR response[49]) that bundles that include TV content or other pay TV elements should be exempt[50] from any margin test and/or that the cost should be excluded. BT did not provide any discernable economic reasoning for this suggestion. In practice, since all of BT's SFBB bundles include some content (whether via TV or an app) BT's approach would mean that <u>none</u> of BT's SFBB bundles would need to pass a margin squeeze test. This would obviously undermine the whole intent of margin squeeze regulation. All retail products that rely on VULA should pass a margin squeeze test. BT is not exempt from the obligations created by

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[48] For instance, the cost of FAPL rights for the seasons 13/14 being amortised across the period August 2013 to April 2014 when BT have exclusive distribution rights

[49] BT's response to Ofcom's consultation document "Fixed access market reviews: wholesale local access, wholesale fixed analogue exchange lines, ISDN2 and ISDN30" … […] … 30 September 2013 ("**BT Response Sept 2013**").

[50] For example BT Response Sept 2013 §21: "*… this means Ofcom should not apply such simplistic and inappropriate testing to BT's provision of fibre services in propositions with Pay TV/content*" and §269: "*Crucially, Ofcom should not seek to constrain BT's pricing of fibre propositions that include Pay TV/content via margin tests on "the numbers"*"

its upstream SMP merely because its downstream bundles offer a number of different elements.

4.6 BT's proposed approach would also mean that the cost of a core element of BT's strategy to build its market share in SFBB is ignored. BT Sport is at its heart another feature or form of marketing for BT's SFBB packages, and should clearly be taken into account in any margin test in the same way that the costs of marketing, modems or other features should also be included. It is not peripheral to BT's SFBB bundles– it is a core element. This can be seen as:

- BT Sport is bundled into BT's SFBB product bundles on a free basis. Conversely, to individuals who are not BT broadband subscribers, BT charges substantial amounts (we understand around [✂] per annum to Virgin Media), and monthly subscriptions of £12 per more per month to individual customers wishing to take the product over the Sky platform.
- BT actively uses BT Sport to promote SFBB products. This can be seen both from BT's statements to the media and investment analysts regarding the purposes of BT Sport, and on BT's policy of imposing technically unnecessary restrictions on access to BT Sport (particularly over BT's TV platforms) unless customers subscribe to SFBB rather than SBB. For example, "*On Sport we always said fundamentally it was about driving broadband first, then fibre*" (Gavin Patterson, Q2 financial webcast, October 31 2013)
- BT Sport has very substantial costs. BT is currently spending in the region of £500m per annum on sports rights and broadcast costs for BT Sport. This is not an element of product bundles that is in any sense merely marginal or insubstantial in the overall costs of offering SFBB. Rather, it is BT's largest single downstream cost category in selling SFBB.
- as Ofcom recognises[51], a rival would, in order to be able to compete with BT if it provides BT Sport for free in a bundle, need to offer BT Sport (in which case it would incur wholesale charges[52]), or offer features with a similar value (and therefore cost) or provide a discount that reflects the lesser value that is included in the rival's bundle.

4.7 The percentage of customers of any other operator who take BT Sport (or state in surveys that they would take BT Sport if it was offered to them) and the marketing focus of individual other operators is of no relevance in determining whether or not BT Sport should be included in the margin test. Competition for customers happens at the margin, not on the basis of averages, and includes both BT competing for other firm's customers, and other firms competing for BT's customers. As BT is willing to pay such significant sums for sports rights, it clearly believes that it has a meaningful number of customers whose decisions regarding their choice of broadband supplier are heavily influenced by sport on TV. As such, not including BT Sport would foreclose downstream competitors from competing for BT SFBB customers.

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[51] Provisional Decision §6.6

[52] [✂]

4.8 If Ofcom were not to include the costs of BT Sport, this would be a clear error by Ofcom. All of the costs of BT's SFBB packages should be included in the margin test. BT Sport is highly relevant to these costs.

4.9 Perhaps because BT recognises the weakness of its initial argument (that triple play should not be tested and/or the cost of BT Sport should be excluded) BT appears to have recently switched tack. It now argues that broadband and sports are different 'markets' and BT is building a standalone profitable sports pay channel[53] that has long term value[54] and because of this strategy the rights costs should be amortised over several years long after the distribution rights expire[55]. The effect of this would be to remove much of the cost of sports rights from the margin test. This argument is wholly unfounded and illogical, for reasons which we explain below.

4.10 First, BT's claim that the reason it spent significant sums on sports rights was to build a profitable standalone pay TV business is diametrically opposed to BT's previous and repeated public statements that BT Sport is designed to increase broadband and particularly fibre uptake and retention. For example:

> *"On Sport we always said fundamentally it was about driving broadband first, then fibre. (Gavin Patterson, Q2 financial webcast, October 31 2013)*
>
> *The key for us is growing our broadband business. We are available on all platforms. If customers do not want to be BT broadband customers, they can pay for the service as well[56]. (Gavin Patterson, quoted on BBC News website, November 9 2013)*
>
> *"We've always made it very, very clear that we've invested in sport to build our broadband business" (Gavin Patterson, BBC News, October 31 2013)*
>
> *"How do we make money out of [BT Sport], which is always the question, when you give something away for free. This tries to summarise that. If you are not a BT broadband customer, or if you are not a BT customer at the moment, this allows us to establish a new billing relationship with you because we will be doing the retailing over the satellite platform, and that is the start of a conversation that allows us to win back the line, the calls, the broadband, ultimately, generating new revenue. If you are existing BT customer, but don't take broadband from us, obviously, we'll use this as an opportunity to sell you broadband, probably fibre, ideally, it allows us to grow ARPU, reduce churn more revenue and, for existing BT broadband customers, obviously, it reduces churn, if you are an existing fibre customer, if you are not a fibre customer, we'll try and sell you fibre, you get the picture".[57]*

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[53] See Sunday Telegraph article: The Sunday Interview, John Petter (17 August 2014). For example, (*inter alia*): "*Petter insists the regulator has taken the wrong approach. BT will argue that sport and broadband are separate markets and should not be bundled together in the test, which is due to come into force early next year. "Clearly they are different markets," he says. "For example the CEO of TalkTalk is quoted saying her customers are more interested in Peppa Pig than they are in sport. And yet on the other side we see it's their argument being made to Ofcom that sport costs should be included in a case on fibre broadband margin squeeze. It's very inconsistent."*

[54] BT appear to have made this argument to Ofcom since Ofcom comments on this idea in Provisional Decision §§6.51-6.52

[55] For example, the cost of FAPL rights for the 13/14 season should be spread over (say) the 5 years from FY13/14 to FY17/18

[56] [✂].

[57] Gavin Patterson at BT Q4 2013 results presentation transcript p15 http://www.btplc.com/Sharesandperformance/Quarterlyresults/PDFdownloads/q413_transcript2.pdf

4.11 That this is BT's actual strategy is reinforced by BT's internal documents referring to this strategy (see, for example, §5.84 of the consultation). It is further reinforced by the way that it has pursued distribution arrangements. If BT were, as it claims, seeking to maximise the value of the standalone pay TV business then it would exploit all distribution channels and, in particular, would seek to sell to TalkTalk customers by at least 'self-retail'[58]. [✂]

4.12 [✂]

4.13 BT has provided no explanation as to why its previous stated strategy has now been cast aside – the only plausible explanation is that this claimed change in strategy is not genuine but rather an attempt to game the prospective VULA margin regulation (and/ or prevent an infringement finding in the CA98 proceedings).

4.14 Second, the current and projected level of rights costs is so high that there is no realistic prospect that a stand-alone sports channel could be profitable for BT. BT Sports is at present heavily loss-making on a stand-alone basis, and those losses are almost certain to increase from August 2015 when BT's acquisition of UEFA football rights becomes effective. There is likely to be further rights inflation[59]. BT's heavy losses are consistent with the experience of Setanta and ESPN who were both loss-making throughout their existence[60] even though they spent less on rights than BT has[61]. It is implausible that BT Sport has a realistic prospect of stand-alone profitability, let alone make substantial super-normal profits.

4.15 Therefore the evidence does not support BT's claim that it can build a standalone profitable pay TV channel. Instead the only cogent rationale for the amount BT has spent on sports rights is to increase broadband (and particularly fibre) uptake and retention, as BT has repeatedly claimed.

4.16 Third, economically it would only be appropriate to recover some of the sports rights cost after the distribution rights expire if either:

- BT was likely to re-win the necessary key sports rights and subsequently earn supernormal profits from its BT Sport channels which would cover the cost of current sports rights; or,

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[58] Self retail is a form of distribution whereby BT sell directly to TalkTalk customers and the channel would be delivered over TalkTalk's IPTV platform. It is the way in which BT Sport is provided to Sky customers who do not take BT broadband.

[59] See, for example, Enders Analysis (2013), *BT Sport Euro football winner – what a price!*, November 13. In this Enders states that '*before the 2015/16 football season even starts, spring 2015 offers the prospect of severe rights inflation as BT takes on Sky for the next three-year PL contract*.' and '*we are rapidly approaching the point at which rights and associated production costs overtake revenues [for BT Sport and Sky Sports taken together*'.

[60] For example, see Enders Analysis, *Setanta at bay* 17th June 2009; Enders Analysis, *BT steps into ESPN's trainers*, 26 February 2013 "*Neither Setanta nor ESPN was able to deliver an operating profit. Both incurred appreciable losses*". Similarly France Telecom in France lost substantial amounts on its standalone sports pay TV channel (which it subsequently closed).

[61] Setanta paid £131m per season, ESPN paid £53m and BT pays £246m

- in the case that BT did not re-win the necessary sports rights, there was value in the channel absent these sports rights which would cover the cost of current sports rights.

4.17 Neither of these scenarios is even close to being plausible:

- BT is not guaranteed to win the sports rights (e.g. the FAPL rights for Aug 2016 onwards) and the rights cost is likely to rise[62] meaning future supernormal profits are highly unlikely, particularly since there may well be additional bidders in the future – both Al Jazeera and Eurosport are possible bidders.[63] The only scenario in which future supernormal profits might be possible would be if BT achieved a monopsony position as the only strong buyer. This seems most unlikely, given that BT is at present considerably weaker than Sky as a bidder for sports rights. In any case, if BT did win the vast majority of the FAPL rights, then TalkTalk would expect it to be subject to commitments to supply other operators (such as TalkTalk) with access to the channels on a FRAND basis, as it would be dominant in the market for premium sports channels which would prevent supernormal profits from being earned.
- TV channels have little persisting economic value once rights are expired since there are few assets (tangible or intangible) that have value as indicated by a number of factors:
  - There is little value in the subscriber base or brand since customers can (and do) easily switch to other channels that win the sports rights they are interested in watching. This is reflected in that sports channels tend to reach maturity quickly, with limited growth in subscriber numbers after the first couple of years;
  - When Setanta and ESPN both lost the FAPL rights the exit value of their business was not material, reflecting the lack of brand or other persisting value;[64]
  - Channel businesses tend to be assessed using short payback periods (less than 3 years) reflecting this lack of persisting value. This contrasts with 'platform' businesses which involve distribution assets (e.g. satellite dishes, set top boxes, IPTV) that have longer paybacks but lower customer willingness to switch.

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[62] see footnote 58

[63] See, for example, http://recombu.com/digital/news/bt-may-go-all-out-for-next-round-of-premier-league-rights

[64] The amount of goodwill BT paid for ESPN in 2013 was £15m. The goodwill reflects the exit value excluding assets and rights/licences and so is comparable to the value absent rights. By any measure the £15m exit value is not material in comparison to the £1.5bn BT will spend on BT Sport in its first three years. From BT Annual report 2014 p149. "*On 1 August 2013 the group acquired 100% of the issued share capital of ESPN Global Limited, together with certain trademarks, licences and programme rights. The purchase was made for consideration of £30m. Intangible assets of £14m and goodwill of £15m have been recognised.*"

4.18 The corollary of there being no material value at the end of the rights term or likely future super-profits is that the cost of rights should be fully recovered over their term (i.e. their economic life).

4.19 Fourth, even if the above three reasons were not true, there are a number of other reasons as to why it would not be appropriate to amortise the cost of rights after the distribution rights expire:

- There would need to be firm evidence that the BT Sport channel had persisting value and/or would make future supernormal profits – no evidence appears to have been adduced by BT to this effect.
- If rights were amortised over a period longer than the period over which BT accrues direct benefit from them, there would be reliance on wholly speculative and arbitrary assumptions to calibrate the margin test.
- The approach would be inconsistent with how BT accounts for sports rights in its statutory accounts[65] and also with generally accepted accounting principles used in the UK (UK GAAP), which is to amortise rights over their useful economic life.
- It would be inconsistent with how BT treats other costs – for instance, BT apparently expenses its TV-related development costs[66] even though these may (unlike rights) have some persisting value.

4.20 Therefore, in summary we agree with Ofcom's proposed approach that triple play packages should be tested, the cost of BT Sport should be included in the margin test and that the cost of sports rights should be recovered over the life of the rights. Any other approach would be economically unsound.

4.21 Regarding other costs involved in BT Sports we think that the same principles should apply, recognising that the channel has little persisting or exit value. We note that channel launch costs are recovered over the first three years (§6.178-6.183); this appears to be an appropriate approach to adopt.

4.2 Ofcom is correct to use the net costs method

4.22 As set out by Ofcom at §6.129 of its consultation document, TalkTalk has consistently argued in favour of the net cost approach to determining the costs of BT Sport which should be allocated to BT's SBB and SFBB customers. At §§6.132-6.136, Ofcom sets out that it is minded to use the net costs approach to determine the relevant costs of BT Sport for the purposes of the margin test.

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[65] BT's accounting policy is to fully recover the cost of rights across the rights period and none of the cost is recovered/amortised after the expiry of the rights. See BT Annual Report 2014 p131: "*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*."

[66] See [✂]

4.23 Ofcom is right to choose this approach. It provides high levels of predictability for BT, which should be well aware of its own costs and revenues for BT Sport. It also creates positive incentives for BT to maximise revenues accruing to BT Sport by wholesaling BT Sport to third parties, or by self-retailing over their platforms. It does not seem to be subject to gaming, as the only factors taken into account are BT's direct costs and revenues derived from BT Sport. Finally, it appears broadly reflective of the commercial realities facing BT.

4.3 Ofcom should allocate a greater BT Sport cost per subscriber to SFBB customers than to SBB customers

4.24 In respect of how the total net costs are allocated between products/customers Ofcom has set out two potential approaches:

- the 'Take-Up Method' allocates the net cost equally amongst customers who take BT Sport, but attributes no cost to customers who do not take BT Sport.
- the 'All Broadband Method' allocates the net cost equally amongst all broadband customers.

4.25 Ofcom then notes (at §6.154) that SFBB customers are more likely to take/subscribe to BT Sport than SBB customers, and that as such the Take-Up Method generates a greater allocation to SFBB products than the All Broadband Method.

4.26 We consider that there are a number of compelling reasons as to why the cost allocation should reflect the take up and usage of BT Sport in order for the margin test to be effective. Frontier discuss this issue in section 5 of their report annexed to this submission.

4.27 First, customers who use and are willing to spend more on BT Sports will *cause* BT to incur (in the long run) more cost since BT would spend incrementally more on BT Sport (e.g. for sports rights) to serve these customers. Accordingly more of the BT Sports cost should be allocated to these customers.

4.28 Second, if customers value BT Sport more, then competitors (who do not provide BT Sport, like TalkTalk and Sky) will have to offer greater discounts in order to be attractive to customers. For the margin test to protect such competitors the cost allocated to these customers must be higher.

4.29 Third, BT imposes, or has imposed, various restrictions on customers being able to watch BT Sport (on TV or via an app) when they are subscribers to BT's SBB products:

- BT Sport over BT TV will only be provided to either customers who take BT Infinity, or who are in areas which do not yet have SFBB available over the Openreach network, despite the fact that it is technically feasible to provide these customers with BT Sport over IPTV.[67]

[67] *'BT Sport 1, 2 and ESPN available in standard definition on BT TV for new and existing BT broadband customers who can't get Infinity. Existing customers must re-contract or have 12 months remaining on their contract.'*. Source: http://www.productsandservices.bt.com/products/tv/sport

- Even where a customer lives in an area which has not been provided with FTTC by BT, a minimum line speed of 5.25Mbps is needed for existing customers to obtain BT Sport via a set-top box, and a minimum line speed of 6.5Mbps for new customers (which will serve to exclude some SBB customer). While BT's minimum speed for existing customers is close to TalkTalk's lower limit for providing channels via multicast [✂] there appears no obvious rationale for setting a considerably higher minimum required speed for new customers.[68]
- BT Sport in HD will only be provided to BT TV customers who take one of BT's Infinity SFBB products. This is regardless of the line speed which the customer is able to obtain over their SBB connection.[69]
- In order to receive BT Sport over BT TV, BT SBB subscribers must re-contract with BT for at least 12 months, and continue to re-contract and remain in contract or BT Sport will be removed from their BT TV bundle.[70] Such a condition does not appear to be imposed on SFBB customers.
- BT Sport is not available online or over an app to customers with a line speed of less than 400Kbps.
- Major League Baseball matches are only available when BT Sport is viewed on TV (it is not available to watch online or over the app).

4.30 This is a very long and complex list of restrictions, which appear to have the aim forcing BT customers who wish to take BT Sport to do so via a BT Infinity SFBB package, rather than as part of an SBB package.

4.31 In the context of the first of these aims – incentivising or forcing BT customers to switch to SFBB products – it is inappropriate and economically unsound to allocate the same proportion of costs to SBB customers as to SFBB customers. BT's restriction on customers watching BT Sport over BT TV on an SBB connection is a pure attempt to use BT Sport to push customers over to SFBB products. The economic corollary of this policy is that more cost per customer should be allocated to SFBB customers than to SBB customers.

4.32 Ofcom sets out at §§6.172-6.176 that the decision between the two approaches is '*finely balanced*', and that the Take-Up Method "*is likely to better reflect the interest of BT's current fibre broadband subscribers in 'free' sports content and BT's commercial and marketing strategy for BT Sport*". However, Ofcom states that it intends to use the All Broadband Method because:

[68] That is, [✂].
[69] See http://www.productsandservices.bt.com/products/tv/sport
[70] '*BT Sport is available on BT TV for new and existing BT Infinity customers who sign up for 12 months or have 12 months remaining on their contract; ongoing renewal needed to get discounted BT Sport.*'. Source: http://www.productsandservices.bt.com/products/tv/sport

- that although the Take-Up Method reflects the preferences[71] of BT's current broadband subscribers, it may not reflect the preferences of marginal customers, who are the customers that competitors are seeking to attract, given the likelihood of heterogeneity of customer preferences for BT Sport. We presume that Ofcom means that other customers who competitors are seeking to address (which includes BT SBB customers, their own SBB customers and other competitors' SBB and SFBB customers) may have different preference for BT Sport and as such BT's SFBB customers may not be representative of the full group of marginal customers;
- that using the Take-Up Method may have adverse impacts on BT's incentives to migrate customers to fibre (§§6.163-6.167). In particular, Ofcom has a concern that BT will be reluctant to migrate customers from copper to fibre if they are BT Sport customers (since doing so would increase the required VULA margin) but would be incentivised to migrate customers from copper to fibre if they are not BT Sport customers (since it would decrease the required VULA margin);
- that under the take-up method BT will have to rely on forecasts for how BT broadband subscribers that take BT Sport are split between copper and fibre in order to set compliant prices.

4.33 We do not agree that it is appropriate for Ofcom to use the All Broadband Method to allocate the net costs of BT Sport. Rather, Ofcom should use the Take-Up Method for allocating costs.

4.34 In reality, Ofcom's concerns are not material and can be dealt with in an effective manner.

4.35 TalkTalk agrees that the customer valuation of BT Sport that is used to allocate BT Sport costs should reflect the preferences of marginal customers that competitors compete for (i.e. contestable customers which we call the 'contestable cohort'). However, the appropriate way to reflect this is not to abandon the Take Up method and use the All Broadband method which evidently does not reflect the preferences at all. If it did this Ofcom would preferring a method that is certainly incorrect (All Broadband Method) for one that is possibly incorrect (Take Up Method).

4.36 One way of reflecting the preferences of contestable customers would be to conduct the analysis based on customers who have been with BT for eight years or less (i.e. are new joiners or have switched in during that time).[72] Such customers are far more likely to be contestable customers who will consider switching provider again than a customer who has been with BT for (say) twenty years. We explain how this can be done above at section 3.2.

[71] By preference we assume that Ofcom means that the level of interest, usage and willingness to pay for BT Sport. In this case, Ofcom's 'preference' concept is analogous to the concept we describe above regarding the value a customer places on BT Sport

[72] In this instance, this would involve calculating the take-up of BT Sport amongst customers who have been with BT for less than eight years, and then using the take-up percentages derived to calibrate the table set out at §4.54 of this submission.

4.37 It is important to highlight that the problem identified by Ofcom (that BT's customers may not be representative of the contestable customers) is inconsistent with Ofcom's adjusted EEO model. The way that Ofcom has applied the adjusted EEO model is that it has used the characteristics (e.g. usage, package mix) of BT's existing customer base as a whole rather than the characteristics of contestable customers (and has not adjusted for any difference in characteristics). As we explain above, adjustments can and should be made to BT's costs to reflect the characteristics of the contestable customer base. This should be done where there is evidence that competitors have different characteristics (e.g. ACL, bandwidth and, as we describe above, call usage). What is concerning in this case, is that Ofcom is effectively proposing to deviate from using BT's characteristics purely based on a hypothesis that contestable customers have different preferences with no evidence that there is actually any difference in preferences between BT's customers and the contestable cohort.

4.38 Regarding the distorted incentives we do not regard this as likely or harmful to competition or consumers. First, the enhanced incentive to migrate customers from copper to fibre if they are not BT Sport customers would almost certainly be welfare enhancing since consumption would expand but there would be no additional cost – there is no reason for Ofcom to be concerned about creating such an incentive. In fact, this is a good reason to adopt the Take Up method. Second, such a strategy (migrating only non-BT Sport customers from copper to fibre) would be very difficult for BT to execute in practice since BT would need to offer different prices. Also such a strategy would imply that BT would be expending less effort in upgrading more committed and profitable customers, contrary to usual commercial incentives. Customers could easily circumvent such a strategy. This concern has been reviewed by Frontier Economics in their paper which is annexed to this submission, and found to be non-credible.[73]

4.39 In fact, using the All Broadband Method will result in harmful incentives. One particular example would be that BT would have the incentive to [✂]. Such a strategy could be profitable for BT since [✂]; but, given the use of the All Broadband Method, [✂]. Such an approach would be harmful since consumption would be reduced (with no offsetting cost savings) and competition would be distorted. This would subvert the margin test regime and allow BT to harm competition as well as directly reducing consumer welfare.

4.40 [✂] This could create serious problems of moral hazard for the future.

4.41 Ofcom does not provide any rationale for why the All Broadband Method provides any materially greater predictability than the Take-Up Method. Effectively, the only additional predictability would be to the extent that BT was better at projecting its number of broadband customers than its number of subscribers to BT Sport. No evidence or rationale is produced as to why this is the case; to the extent that it can be demonstrated, TalkTalk can see no reason why any such difference in predictability should be significant.

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[73] At §5.52*ff*

4.42 Lastly, we note that the All Broadband Method has the perverse characteristic that effectively the cost of BT Sport is allocated to customers who do not use or take BT Sport, and the allocation of BT Sport costs between SBB and SFBB depends on customers who have no interest in BT Sport.

4.43 Therefore, in summary there are no meaningful concerns over using the Take-Up Method rather than the All Broadband method. None of the potential issues raised by Ofcom are robust under scrutiny, and none are even close to being sufficient to outweigh the improvement in the cost causality of allocations due to using the Take-Up Method.

4.3.1 Survey data supports moving away from an equal cost allocation per broadband customer

4.44 As explained above, the allocation of the net BT Sport cost should reflect the relative value different customers attach to BT Sport and their relative willingness to pay for it. The relative value should reflect both whether subscribers taking particular product groups access BT Sport (i.e. the level of take-up) as well as that those customers who access via TV (who are likely to likely to value BT Sport more highly). In our previous submission we suggested that the value of viewing on TV was four times that on an app only. Ofcom seemed not to have any in principle objection to such an approach though it said that the assumption of a four times multiple "*lack[ed] evidential support*" (§6.129).

4.45 Accordingly, in order better to understand the appropriate allocation approach for the costs of BT Sport, and the types of customer behaviour around BT Sport and BT bundling of it with SFBB, TalkTalk commissioned a survey from Ipsos MORI.[74] The details of this survey are annexed to this document. TalkTalk will also supply the raw data from the survey to Ofcom for it to undertake its own analysis. If Ofcom does not consider the survey robust enough, we would expect Ofcom to commission its own survey given the importance of this issue.

4.46 The aims of the questionnaire were to consider several issues:

- how access to BT Sport varies between customers on SBB and SFBB products from BT;
- what methods customers use to watch BT Sport at present;
- how customer valuations change depending upon whether customers view BT Sport via their set-top box, via an app, or on a PC over the internet;
- how customers' viewing habits change depending upon whether they view BT Sport via their set-top box, via an app, or on a PC over the internet;
- whether, overall, customers with SFBB place a higher value on BT Sport than those with SBB.

[74] Ipsos MORI undertook the fieldwork for this survey, but all analysis and interpretation of the survey results is TalkTalk's, and should not be ascribed to Ipsos MORI.

4.47 The questionnaire was asked to 1,331 BT Broadband customers. Individuals taking broadband from other CPs and those taking broadband from Plusnet were not queried. The data were cleaned to remove internally inconsistent responses. Responses were reweighted to be representative of BT's broadband base, using a profile taken from the Ipsos Tech Tracker.

4.48 Of these 1,331 BT Broadband customers, it was found that 850 (64%) stated that they had access to BT Sport. 60% of SBB customers have access, compared to 70% of SFBB customers.[75] This likely reflects to some degree the restrictions BT impose on SBB customers getting BT Sport as well as any correlation between those interested in SFBB and those interested in BT Sport. The data implies that there will be a higher valuation on BT Sport per SFBB customer than per SBB customer, *even if the valuations of customers with access are the same for SBB and SFBB customers.*

4.49 Below we discuss how the results of the survey can be used to produce a evidence based weighting for the allocation of BT Sports costs between SBB and SFBB customers.

4.50 Where customers did have access, those who tended to watch it on TV (rather than on a tablet, PC or smartphone) were found to have a higher willingness to pay. Those respondents whose primary access method was via a TV box were on average willing to pay £3.59 per month, compared to £1.85 per month for those whose primary access method was not via TV. This is a significant difference.[76]

4.51 As would be expected given the relative valuations, individuals who accessed BT Sport via set-top boxes spent significantly more time watching BT Sport than those who accessed BT Sport via other means. On average in the seven days prior to the survey being undertaken, those respondents who used set-top boxes as their main access method watched 1.5 hours of BT Sport, compared to 0.7 hours for people primarily accessing by other devices.

4.52 The higher value placed on TV is also reflected in that consumers who have a choice of viewing on TV or the app prefer viewing on the TV. Few respondents stated that they watched on devices other than a TV as their primary method for accessing BT Sport. 372 respondents stated that they watch primarily via a TV, and 270 via all non-TV devices. This is notwithstanding that all BT broadband customers are now able to access BT Sport over tablet or PC, whereas only those with BT TV or Sky TV can

[75] The difference in access is significant at the 5% level.
[76] Note that TalkTalk is not arguing that the absolute values provided by the two groups of customers can be directly applied– they are likely to be subject to various downward biases such as:

- customers may have considered it likely that the survey was due to BT assessing how much it could charge for BT Sport. As such, there is a strategic incentive to understate customers' true valuations, in order to push downwards the charge that they may be asked to pay.
- The survey was conducted before the Premier League football season had started so the main attraction of BT Sport may not have been fully reflected in customer valuation estimates.

There is no obvious reason why this bias (or any other bias) should differ depending upon whether customers have access to BT Sport over their TV, or only via an app; as such, the ratio of the two groups of customers remains instructive and robust, even when absolute values are not.

access BT sport through their set-top box (i.e., those with Freeview cannot access in this way).

4.53 The implication of all of the above for the appropriate weightings of value for each category is as follows:

- No access: 0
- Access via app: 1.0 (normalised to 1)
- Access via TV: 2.3[77] (= 3.59 / 1.85 based on the relative valuations)

4.54 These relative weightings can be applied to the proportion of customers in each category to derive a relative value of BT Sport to SFBB customers versus SBB customers.

	No access	**Access via PC/ app**	**Access via TV**	**Weighted average value**
Relative value	0	1.0	2.3	
SBB	35%	27%	38%	1.14
SFBB	24%	20%	56%	1.49

4.55 Thus the relative value a SFBB customer places on BT Sport (compared to a SBB customer is 1.31 = 1.49/ 1.14 (i.e. 31% more).

4.56 The second method simply directly compares the monthly willingness to pay for BT Sport. BT customers with access to BT sport have different valuations depending upon their method of broadband access: for SFBB customers (£3.39) and SBB customers (£2.52). This means that for customers with access to BT Sport, SFBB customers value BT Sport 39% more than SBB customers. This figure then needs to be adjusted upwards to reflect that 17% (= 70%/60%) more BT SFBB customers than SBB customers have access to BT Sport. Overall, therefore, the average BT SFBB customer values BT Sport by 58% (=1.17 * 3.39 / 2.52) more than the average BT SBB customer. This provides a second estimate of the required ratio of cost attributable to SFBB and SBB customers.

4.57 As such, survey data strongly supports the case that there should be a material difference in cost allocation between SBB and SFBB customers. This difference in allocation should range between 32% and 58% more cost being allocated to SFBB customers than to SBB customers.

4.3.2 Conclusions on the All Broadband Method

4.58 Given BT's restrictions, and the usage and willingness-to-pay characteristics of SFBB customers compared to SBB customers, the All Broadband Method cannot be the appropriate way of allocating costs between SBB and SFBB customers. Effectively,

[77] This figure of 2.3 is analogous to the estimate of four times that we provided in our previous submission.

using the All Broadband Method permits BT to allocate an excessive quantum of costs to SBB customers, artificially inflating the observed profitability of SFBB customers.

4.59 As such, Ofcom should instead choose an approach to allocating broadband costs which allocates a greater proportion of costs to SFBB customers (reflecting greater access to BT Sport) and to customers who view BT Sport on TV (reflecting greater willingness to pay for BT Sport).

5 Appropriate approach to mobile

5.1 Section 4 of this consultation response set out our response to Ofcom's proposals as to how the costs of BT Sport should be taken into account in a margin squeeze test. This is one additional element that BT has inserted into its SFBB bundles over the past year.

5.2 In the future, it is highly likely that BT will bundle more features into its SFBB bundles. Mobile appears the most likely of these, creating so-called 'quadruple play' bundles. As Enders Analysis stated in an 5 August research note:[78]

> *In July, BT took its first step in relaunching mobile, announcing BT One Phone, a product aimed at SMEs... BT is planning on launching a consumer product before the end of March 2015*.

5.3 This is a similar view to that expressed by the Financial Times in a 17 July article:[79]

> *BT will return to the mainstream mobile market for the first time in a decade... the British telecoms group will launch consumer offers towards the end of the year that will bundle mobile as part of its TV and broadband packages*.
>
> *Consumer offers are expected to be low priced – or even free according to some analysts – when bundled into a package of its telecoms and entertainment services. BT already uses its TV platform – where it has invested more than £2bn in buying rights to show on dedicated sports channels – to encourage take-up of superfast broadband.*

5.4 In the same Financial Times article, BT's CEO Gavin Patterson was quoted as saying that:

> *Later in the year [2014] we will come back to the consumer market and I think you'll be excited*.

5.5 On the basis of these quotes, and other similar ones in both the mainstream and specialist press, TalkTalk would expect that BT will, in the next six months, launch bundles containing mobile products as well as SFBB.

5.6 In this section we discuss how the impending launch of mobile in SFBB bundles should be reflected in the margin test.

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[78] Enders Analysis (2014), *BT Q1 2014/15 Results: Solid Q1, but battles to come*, 5 August
[79] Financial Times (2014), *BT returns to mainstream mobile market*, 17 July

5.1 Mobile services must be included in the margin test

5.7 It is clear from the economic logic of Ofcom's proposed approach to margin squeeze regulation that:

- bundles that include both mobile services and SFBB should be included in the margin test (else BT could circumvent regulation simply by including mobile in a bundle); and,
- the costs of providing mobile must be included in the margin test (else operators with some slight cost disadvantage would not be able to compete effectively with BT).

5.8 Indeed, Ofcom has already addressed a similar set of points at §5.83 of its consultation document in regard to content / BT Sport:

> *... excluding triple play bundles could lead to BT being able to circumvent the aims of our proposed SMP condition. For example, if triple-play packages were excluded, BT could set a negative margin on its triple-play package and a positive margin on its dual-play packages. If triple-play packages were not taken into account BT would appear to be setting an adequate margin, based solely on its dual-play packages. However, assessed on an aggregate basis (i.e. looking across both dual-play and triple-play in aggregate) the VULA margin could be negative. As a result, other operators would be unable to profitably match BT's offers overall – they would effectively be excluded from the triple-play segment*.

5.9 The same argument as Ofcom set out in its paper for triple-play bundles containing TV products also applies to bundles containing mobile products.

5.10 The quotes set out at §§5.2-5.4 above appear to indicate that BT is considering a policy of setting a below-cost price on SFBB bundles including mobile. If BT's portfolio of SFBB bundles without the inclusion of mobile is close to the minimum required margin, then if there is a zero (or a very low) incremental charge for including mobile, BT will almost by definition be setting a margin below cost. Given that BT is already close to the required margins across its whole SFBB portfolio, introducing loss-making products is highly likely to result in a margin squeeze.

5.11 It may be that BT is hoping to use bundles containing mobile to circumvent the proposed margin squeeze regulation. Ofcom should avoid this risk by making clear in its draft guidance:

- that bundles containing mobile will be subject to margin testing;
- that the cost of providing mobile services will be included in the margin test; and,
- how the costs and revenues of mobile services will be taken into account.

5.12 The only situation in which Ofcom should not take the costs and revenues of mobile into account when conducting a margin squeeze test would be if BT's mobile products are offered at the same incremental consumer price[80] when they are taken

[80] Or in the unlikely event that the standalone price was less than the additional price in the bundle

on a stand-alone basis as when they are taken as part of a bundle.[81] That is, there is no advantage to taking them as part of a bundle, and that broadband customers of other providers will be able to 'replicate' BT's bundles by buying mobile from BT, and SFBB from another CP.

5.2 The methodology for taking mobile into account

5.13 In this section, we describe how the costs and revenues of mobile services should be taken into account in assessing whether BT complies with the proposed VULA margin squeeze testing regime.

5.2.1 Revenues from mobile

5.14 There are several different categories of revenue from mobile which Ofcom should take into account in its margin test:

- *handset charges*– any revenue from handset charges paid by SFBB customers;
- *activation charges*– the revenue if BT chooses to levy any activation charges for its mobile product (as it does for its TV product);
- *monthly charges*– any incremental revenue from monthly charges (above the monthly charges payable by customers who take SFBB bundles without mobile included);
- *call revenue*– out-of-bundle call revenue – Ofcom can simply include the post-VAT mobile call revenues for SFBB customers in its overall assessment;
- *SMS revenue*– similarly, Ofcom can in its model include revenue derived from SMSs sent by SFBB customers;
- *data revenue*– Ofcom should include post-VAT out-of-bundle data revenue derived from SFBB customers;
- *mobile termination revenue*– revenue received by BT for terminating calls to mobile phones on its network (where the calls are terminated using BT's own spectrum and base stations, rather than via an MVNO deal).

5.15 The above list is not exhaustive, but should cover most of the main categories of retail charges which BT might incur as a result of offering mobile services.

5.2.2 Variable costs of mobile

5.16 In general, it should also be relatively easy to identify and allocate the variable costs of providing mobile. The key variable costs are likely to be:

[81] In this context, incremental consumer price is taken in its widest sense, including both the incremental monthly charge and the charges for variable items such as out-of-bundle calls, SMSs, data, and handsets.

- *outbound termination payments*– payments made by BT to terminate calls made by their mobile customers on the networks of other operators[82] should be taken into account in the margin test;
- *payments to MVNO partners*– payments made by BT to their MVNO partner(s) (i.e. EE) for call origination for outbound calls from BT's mobile customers, and for call termination for inbound calls to BT's mobile customers, should be taken into account in the margin test. In the same way, origination/ termination payments to MVNO partners for data and SMS usage should be taken into account;
- *additional customer service costs*– to the extent that customers taking BT bundles including mobile incur additional customer service costs, over and above the costs incurred in serving SFBB customers who do not have packages which include mobile, then these costs should be included in the overall test. We note that in its guidance Ofcom proposed that customer service costs were allocated using a "BT breakdown"[83]. It may be that the same method can be used for additional customer service costs resulting from mobile.

5.17 As such, there should be few difficulties allocating the variable costs of mobile to SFBB bundles containing mobile services.

5.2.3 Subscriber acquisition costs for mobile

5.18 There will likely be additional subscriber acquisition costs (SACs) for acquiring customers who take bundles featuring mobile as well as BT's current combination of SFBB, line, calls, and TV.

5.19 Amongst the most important of these incremental SACs is likely to be additional costs for routers. If BT chooses to roll out its network partially or wholly based on femtocell technology [✂], then this will entail additional router costs to cover the costs of the additional router functionality. These additional router costs should be taken into account when assessing the profitability of bundles containing mobile.

5.20 There are likely to be two cases where higher router costs are incurred:

- In the homes of customers taking the mobile service. In this case the cost of the routers included in the subscriber acquisition costs of mobile should be the whole router cost;
- In the homes of customers <u>not</u> taking the mobile service. BT may incur these costs in order to extend the reach of its network. In this case only the *additional* cost above the standard router should be included in mobile costs. These might not be included as a subscriber acquisition cost but rather an operating cost – see §5.30 below

[82] The cost of terminating calls on BT's network should be included – see section 6.2
[83] VULA Margin Consultation Draft Guidance Table 3

5.21 These costs (in the first case) should be amortised over the life of the router and allocated across all of the customers taking mobile packages over that period.

5.22 A worked (simplified) example of how this could be done is as follows:[84]

- assume that BT issues 1m routers containing femtocells in year 1, and that each router has an expected lifetime of 3 years. Assume that no further routers containing femtocells are issued before year 4. Further, assume that a router with a femtocell included costs £60 more than a router without a femtocell. As such, BT spends £60m in year 1, and then £0 in years 2 and 3. By year 4 all of these routers are depreciated.
- Assume that BT has 0.2m customers in year 1, 0.5m in year 2, and 0.8m in year 3. There are therefore 1.5m customer-years of mobile subscription.
- As such, the cost per customer-year is £40 (£60m / 1.5m). A recurring annual cost of £40 should be allocated to each customer on an SFBB package that includes mobile .

5.23 Given the simplicity of this approach to allocate the costs of upgraded routers across customers who take SFBB, we think that it would be easy to operationalise in practice.

5.24 A complicating factor is that there may be some routers replaced before the end of their working lives in order to facilitate the roll-out of a femtocell based network. Where this is the case, the undepreciated quantum of router asset value from the replaced router(s) should be attributed to mobile products (rather than just the incremental cost of putting a femtocell in the router). Such an allocation is based on cost causality: as BT's mobile roll-out is causing routers to be replaced before they are life-expired, the cost of the routers should be attributed to mobile products.

5.25 A second key category of subscriber acquisition costs is the cost of subsidised handsets for customers who take a bundle including mobile telephony. Ideally, this can be taken into account simultaneously on the revenue and cost side of the analysis by determining both the total charges for handsets payable by BT customers in each year, and the cost to BT of acquiring those handsets. Importantly, where BT over-acquires a particular type of handset from a manufacturer, it should not be permitted to write off the costs of unsold handsets; rather, they should be taken into account when conducting a margin test, and allocated across the customer base taking BT mobile products, including those on SFBB bundles including mobile telephony.

5.26 There are also likely to be considerable additional marketing costs from BT providing SFBB bundles featuring mobile telephony, rather than just broadband, voice and television. Based on previous product launches (such as BT Sport), BT appear to have a clear preference for launching new products supported by heavy advertising

[84] This example abstracts, for example, from adjusting for the opportunity cost of money, meaning that later cost allocations will need to be increased to meet the discounted present value of router costs.

expenditure. The costs of this launch advertising should be allocated to customers taking mobile customers from BT, including those customers taking mobile from BT as part of a bundle built around SFBB. The costs of this launch marketing could be allocated to customers over a suitable period (for example, the average customer lifetime of customers taking mobile products from BT). They should exclusively be allocated to customers taking mobile products.[85]

5.27 Any other types of subscriber acquisition costs that are incremental to BT offering mobile bundles should be allocated in a similar way to the above. In general, the core principle is that these costs should be allocated in a broadly causal manner or, in other words, that the costs of mobile should be allocated to mobile customers.

5.2.4 Allocation of other costs of offering mobile

5.28 There are a number of other costs caused by providing mobile service where the appropriate allocation is not as obvious as for the costs described above. Some of these costs will be fixed, and some variable.

5.29 Some of these costs effectively raise similar issues as those generated by BT Sport – for example, how to allocate a cost that does not directly vary in the short run across the number of customers on a particular product, but is a long-run incremental cost of offering the set of products that include mobile as part of the bundle. All of the above costs should be included as part of either a LRIC or LRIC+ based test of product margins.

5.30 There are four main categories:

- *Spectrum costs*– the sums which BT has paid to acquire 4G spectrum in Ofcom's auction (dated 20 February 2013).
- *Costs of base-station roll-out*– in order to make use of its 4G spectrum, BT may engage in some base station roll-out.
- *Costs of femtocell routers*– as described above at §§5.19-5.20, BT may deploy femtocell routers in homes of customers who do not take a mobile service.
- *Costs of renting base station capacity from other operators*– in some areas, rather than rolling out its own base stations, BT may choose to rent base station capacity from other operators.

5.31 Each of these raises two questions:

- how the cost should be recovered (amortised) over time;
- how the cost should be allocated between different customers/ bundles.

5.32 Regarding amortisation, unlike for BT Sport, there is no well-defined period after which the spectrum rights expire (which provides a simple and appropriate metric

[85] In the context of an SFBB margin test, this might involve determining (for example) that 5% of BT's SFBB customers take mobile products, and then giving an allocation weight of 0.05 to all mobile costs in SFBB margin squeeze determination.

for apportioning costs over time); 4G spectrum was granted on the basis of an indefinite licence.[86] However, Ofcom states that it may withdraw the licence '*for spectrum management reasons*' after a 20 year minimum term has expired. As such, we consider that it would be appropriate for Ofcom to depreciate spectrum costs over a 20 year term when assessing the costs of spectrum to be allocated to bundles including mobile telephony. There should also be an interest cost applied to the undepreciated value in each year (at the WACC of the Rest of BT, currently 10.8% per annum).

5.33 BT paid £201.5m for 4G spectrum. Adopting straight-line depreciation of this over 20 years gives a depreciation charge of £10.1m per annum. There will then also be an interest charge on the undepreciated amount, which will be 10.8% of the undepreciated amount; in the first year, this would be approximately £21.2m. As such, the spectrum charge to be recovered from customers taking BT packages that include mobile would be around £31m in the first year.[87]

5.34 For the other costs:

- base station roll-out costs could be amortised over the term over which they are depreciated for statutory purposes;
- femtocells similarly should be amortised over their useful life;
- base station rental payments should be recovered in the year the cost is incurred.

5.35 There are a number of possible methods (e.g. equal per customer, in proportion to data used) for allocating these costs amongst different customers. We think that the same principles articulated above for the allocation of BT Sport apply here – the allocation should reflect the long run incremental cost a customer would cause to be incurred, or the value that customers attribute to the service (see section 4.3 above). We think that the most appropriate approach would be to allocate these costs in proportion to mobile data used since several of these costs vary in the long run in response to data throughput, and also the value a customer is likely to attribute to the service is likely to be linked to the amount of data they use. This would appear to be an appropriate and cost causal approach, which would provide clarity and predictability for BT.

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[86] Ofcom (2012), *The Award of 800Mhz and 2.6Ghz spectrum: Information Memorandum*, at §4.8

[87] In reality, this will be an underestimate. BT paid for its mobile spectrum in Q1 2013, and as such has had no recovery against this value as yet. If BT launches mobile products which make use of its 4G spectrum in Q1 2015, it will have to also recover two years of capital charges for holding the spectrum unused on its balance sheet (i.e, an extra £40m). However, this additional charge can only be determined when BT launches products that make use of 4G spectrum, and so is at present uncertain and not taken into account in the main text. Adding in a two year waiting period before rolling out products would take the annual spectrum charge up from around £31m to over £38m.

5.3 Conclusions on mobile telephony

5.36 Ofcom must, in its guidance, set out both that if BT launches mobile services that bundle together SFBB and mobile services, these bundles will be subject to a margin squeeze test. The guidance should also explain how the revenues and costs of mobile services will be reflected. Adopting any approach other than this would risk rendering the proposed margin squeeze regulation ineffective.

6 Other margin test assumptions

6.1 This section covers a number of other relatively more minor comments on Ofcom's consultation.

6.1 Bandwidth

6.2 We fully agree with Ofcom's imposition of a minimum bandwidth cost, based on the costs of Sky and TalkTalk and their trends over time. Imposing such a bandwidth cost floor will minimise the detrimental impact of cost allocation gaming which we would otherwise expect BT to undertake in order to reduce the required margin. However, [✂].

6.3 With regard forecasting the bandwidth cost floor, the most effective way to operationalise changes in the unit cost of bandwidth– [✂] is to simply [✂]. This is likely to be [✂].

6.2 Average customer lifetime

6.4 As regards average customer lifetime (ACL) Ofcom has adopted a pragmatic position by opting for an ACL of 5 years, reflecting competitors' SFBB ACLs and BT's SBB ACL, rather than BT's actual SFBB ACL from time to time. This has a number of advantages:

- it correctly reflects a rival's customer characteristics (which do not include non-contestable inert customers) and so correctly reflects the EEO;
- there is no sound reason to believe that BT's SBB will not be an appropriate indicator of future nature level churn on SFBB – for example, BT has not seen any improvement in customer service that would reduce churn. In fact the introduction of the gaining provider process for migration is likely to raise churn and reduce ACLs.
- it is easily understandable by both BT and other stakeholders; and,
- it avoids fluctuations in measured profitability if there are short-term factors impacting on ACLs.

6.3 Cost allocation

6.5 Ofcom has proposed allocating variable shared costs to SFBB in proportion to the number of additional customers (i.e. acquisitions), the customer base or the number of products taken. Based on Ofcom's document this approach seems broadly sound.

6.6 We have the following comments about particular types of cost:

- We understand that Ofcom has allocated costs that it considered to relate to customer acquisition equally between all customer acquisitions[88]. We think that a better way of allocating at least some of these acquisition related costs should be to reflect the number of products that are being sold (or the quantum of revenue from the customers). This will appropriately reflect that acquisition costs will be higher where, for instance, a there is a bundle including line, calls, SFBB and TV rather than just a line and calls[89]. This makes intuitive sense, in that more is invested in acquiring customers who generate greater revenue/margin.
- Ofcom allocates customer retention costs in proportion to numbers of customers[90]. Customer retention costs should reflect the number of products taken since BT is likely to spend more retaining customers who take more products, as they generate higher revenue.
- Ofcom allocates billing and bad debt costs in proportion to numbers of customers[91]. Ofcom should base the allocation of bad debt and billing on the basis of the number of products sold (or better still in the case of bad debt, on the revenue of each product). It is intuitive that the level of bad debt and complexity of billing would increase with the number of products a customer takes (or revenue in the case of bad debt).
- Ofcom allocates peering/platform costs equally across all broadband customers (§6.92 of the consultation document). These costs are for the provision and management of peering and transiting. This cost should be allocated in proportion to the bandwidth used by different customers – in the same way as network costs are allocated in proportion to the bandwidth used by different customers (and using the same data). The volume and spend on peering/transiting (which is effectively the link into the Internet) is proportional to the capacity of the links.
- It is not clear if or how shared BT Group costs are allocated <u>to</u> the BT Consumer division (and then onto SFBB products)[92]. For example, they are not referred to in any of the draft guidance tables. These costs should be included (in full) in any LRIC+ based test (using an appropriate allocation).

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[88] VULA Margin Consultation §6.214
[89] Indeed we understand that some marketing costs (non-campaign costs) related to existing customers Ofcom allocates based on the number of products taken – this further supports the case that marketing costs for acquisitions should also be allocated reflecting the number of products sold.
[90] VULA Margin Consultation Draft Guidance Table 3
[91] VULA Margin Consultation Draft Guidance Table 3
[92] within BT Consumer we understand that the allocation is effectively in proportion to customers and/or products taken

Most of these costs should be also included in a LRIC based test since the vast majority of BT Group overhead are in fact (in the long run) incremental. It appears that Ofcom consider shared BT Group costs as fixed and common (see §6.101). They are not all fixed and common.

- If the allocation is based on the method in BT's RFS (which allocated on the basis of weighted assets and FTE) then we consider it to be inappropriate since the RFS does not reflect the true manner in which BT Group costs will change in response to increases in SFBB volumes[93]

6.7 We consider that these changes in methodology could easily be applied in the case of product-by-product tests.

6.8 We note that Ofcom says that some acquisition costs are allocated to regrades. However, it is not clear what acquisition related costs are allocated to regrades and which are not (and on what basis). This is important since many of the SFBB customers BT has will be regrades. Ofcom should make its assumptions in this regard clear.

6.4 Other assumptions

6.9 BT's competitors who use VULA predominantly use MPF to offer SBB services. Therefore, for the adjusted EEO to reflect the realistic costs that an efficient scale competitor would incur the margin test needs to include a migration from MPF to WLR in the case where a customer upgrades from SBB to SFBB (since the Ofcom test is predicated on providing SFBB bundles based on WLR – see §5.118). This cost is £30.83 and should be included as an upfront cost.

6.10 Where voice calls from SFBB customers are terminated on BT's own network then no termination costs is included in Ofcom's margin test (either as a cost incurred by BT or a charge paid). This is not correct. If the call terminates on BT's network there will be an incremental cost incurred by BT to provide this service. This cost must be included. A pragmatic way to include this cost would be to apply the standard BT fixed termination charge since this is set at the LRIC.[94]

6.11 BT's cost estimates (which Ofcom has adopted) for event charges only included expedites, abortive visit and modify upstream orders charges. SFI and TRC charges (which relate to fault repair not included in the standard charge) are not included since (see §A1.146):

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[93] BT allocates certain BT Group and TSO costs in proportion to weighted assets which does not reflect causality since the vast majority of the costs are in no way caused by assets – instead they are caused by the level of revenue, opex, headcount and capex. BT allocate using assets since this leads to the greatest allocation of cost to regulated products.

[94] At alternative way of viewing this (which comes to the same answer) is to look at the termination cost that would be incurred by a competitor (which reflected the adjusted EEO). Such an operator (which used WLR) would have to pay to terminate all calls since they would not be able to terminate calls themselves. In this case all calls would incur a fixed termination charge.

- if the fault is on the customers network the charge is fully passed onto the customer; or,
- if the fault is on Openreach's network then there is no charge.

6.12 [✂][95]

6.13 The current GEA product includes a minimum contract term which means that a CP has to pay outstanding rental charges in the case that a CP cancels the GEA rental within the first 12 months[96]. This results in a cost for downstream rivals. This cost should be reflected in the margin squeeze cost as an additional wholesale cost.

6.14 We note that Ofcom has not included any cost for providing Wifi (§6.96). This seems unjustified since it would be highly unusual that a service could be provided without incurring any costs.

6.5 Use of the RFS

6.15 In developing its cost estimations it appears that Ofcom has used a variety of sources from BT including its management accounts and the RFS[97]. This raises the risk of inconsistencies [✂] since [✂]. For example [✂].

6.16 The use of the RFS also allows BT to game cost allocations and therefore the margin test. We have two concerns in this case

- It appears that Ofcom's assumptions are based on the RFS 2012/13. However, these accounts have been robustly (and rightly) rejected as a basis for setting LLU, WLR and WBA charges and similarly they cannot be relied on to set the VULA margin[98]. In particular in the RFS 2012/13 BT allocated Openreach overhead costs on weighted assets and pay rather than just pay; while BT TSO capitalised development assets were allocated on the basis of the TSO managed assets base, rather than on the basis of pay.[99] This allocation which resulted in more allocation to regulated products and less to non-regulated products (like SFBB) was rejected by Ofcom. Therefore, arguably the margin test should not be based on RFS 2012/13 data.
- That there is an urgent need for Ofcom to implement its decision to take more control of allocations.

[95] [✂]
[96] see FAMR Consultation July 2013 § 11.198 .
[97] Ofcom has used the RFS for bandwidth costs (§6.62) and it also refers to using them (or the RFS methods) to derive some other retail level (e.g. draft guidance below §6.213 and §A6.61)
[98] See FAMR Statement June 2014 Annex 22
99 BT (2013), *Report requested by Ofcom describing certain changes to the Accounting Documents for the year ended 31 March 2013 and illustrating the resulting differences to the Current Cost Financial Statements had those changes not applied*, 5 October, at pp. 31-32

7 Ensuring compliance

7.1 VULA margin regulation will only be effective in promoting competition if BT's pricing complies with the requirements of the margin test at all times – this will depend on an effective compliance regime. In this section we discuss the appropriate approach for Ofcom to adopt in order to maximise the chances that BT complies whilst ensuring that the burden on BT and Ofcom is proportionate and not excessive.

7.2 There are two key inter-linked objectives within an effective compliance regime:

- strong incentives for BT to comply (i.e. to prevent a margin squeeze); and,
- a system that quickly and reliably detects any instances of non-compliance.

7.3 Reflecting these objectives, we think there are a number of improvements to Ofcom's proposals that will collectively increase the chance that BT will comply with the proposed margin squeeze testing regime.

- **Greater clarity** on the method and assumptions of the test, so that BT has a high degree of certainty of whether its wholesale and retail prices are compliant – this will increase regulatory certainty, reduce the opportunity for BT to game the system by selecting assumptions which favour it, and will also increase the fines that can be legitimately be imposed in the case of non-compliance, increasing the deterrent to BT (since BT will have less excuse for non-compliance).
- **Strengthening of the *ex post* testing regime** to ensure that breaches are detected correctly and quickly including: a system that quickly produces a clear pass/fail result (rather than a vague 'high level assessment'); publication of the result (i.e. whether there is a pass or fail); and, audit of the data BT provides to avoid the ability for BT to provide inaccurate and self-serving data.
- Filing of new product (or major price changes) margin tests before they are launched ('**pre-launch test filing**') to reduce the chance of non-compliant products being offered to customers and causing harm to competition
- **Clarity of fines and what will happen in the case of a breach** both in terms of how Ofcom may consider imposing fines and also what other remedies might be imposed. This will help create a clear and strong deterrent on BT not to breach and so increase its incentives to comply

7.1 Greater clarity

7.4 Clarity of how the margin will be analysed is central to the success of the regulation. Ofcom set out that its objective was to "*clearly [set] out the minimum margin*" (§2.5) and to identify the single approach that is most reasonable (§6.3). If the method and assumptions used to test the margin are not clear and unambiguous then [✂]:

- BT will [✂]. A similar problem has occurred over many years [✂][100].
- [✂].

7.5 We therefore believe that there should be a very high degree of clarity to help ensure compliance – ambiguity is the enemy of compliance.

7.6 Our main suggestion is that Ofcom should provide a clearer statement of the nature of the revenues and costs that the adjusted EEO should reflect. As we described in section 3.1.2 we do not think it is currently clearly enough defined.

7.7 Ofcom has proposed four legal/regulatory options that provide varying degrees of clarity (§4.49). We have the following comments on these proposals:

- One of the issues Ofcom discusses is whether to include the method/assumptions in guidance or an SMP Condition[101]. We consider that both of these provide broadly the same degree of certainty to BT (since they can both include the same words). An SMP Condition might provide greater *legal* certainty than guidance. However, conversely an SMP Condition is more difficult to modify in the case of changing circumstances (for instance the method and/or assumptions to be used in the case BT offers mobile services). If the method and/or assumptions were included in an SMP Condition it might mean that Ofcom would be reticent to change the method/assumptions when they become out-dated given the administrative burden involved in modifying an SMP Condition. This might result in stasis and an out of date margin test. Accordingly, we are not convinced on the need to include any (or many) of the details of the method or assumptions within an SMP Condition.
- Ofcom highlights the option of including a model (i.e. Excel spreadsheet) as part of an SMP Condition – option C at §4.58ff. Whilst we agree that the inclusion of a model within the SMP Condition might be unwarranted the written details that are provided (within guidance or an SMP Condition) should be sufficiently clear and unambiguous to enable an Excel spreadsheet to derive the margin to be developed.
- In respect of new services that BT might launch (such as mobile) Ofcom should provide as much guidance as it reasonably can at this stage (i.e. in the Statement) and, if need be, update the guidance if/when a new service is launched. This might mean, in the case of mobile for example, that in the Statement Ofcom describes (say) that spectrum costs should be included based on an annuity. Such guidance will not create a barrier to BT launching new products, but it will ensure that BT will reasonably reflect the costs from the launch of the new product. As more information becomes available the guidance can be adapted and improved. Ofcom needs to consider under what circumstances and how it would go about modifying/updating

[100] [✂]

[101] Ofcom seems to suggest, for example, that Option B encapsulates more of the detail within an SMP Condition and provides therefore more certainty

guidance[102]. It is worth noting that having a clear exposition of the nature of the adjusted EEO will also help identify how new services should be treated

- We agree that option D would be inappropriate (a fixed margin in absolute monetary terms). If this were adopted it is likely BT would simply redesign its products to include more features (and more costs) to avoid the margin test preventing anti-competitive pricing. Such an option is liable to lead to both false positives and false negatives.
- We do not think that Ofcom need be overly concerned about its assumptions becoming out of date (save for the comments above regarding new products such as mobile) since, given the delay in the VULA margin being introduced, it is now only likely to be in force for only about 24 months.
- We presume that BT will need to be compliant with the margin test in the first test (which covers the first month after the Statement and is provided to Ofcom two months after the Statement – see §4.80). There should be little difficulty in BT complying with this margin test, since if it found a margin squeeze based on its (then) current prices it could remedy this immediately by reducing wholesale GEA charges.

7.2 *Ex post* testing

7.8 The core of Ofcom's proposed enforcement approach is a requirement on BT to provide Ofcom with data necessary to monitor compliance every 6 months i.e. option (i) (§4.80). We agree with *ex post* testing though, as we explain below, we think that if it were complemented by pre-launch testing the incentives to comply and degree of compliance would improve. We have a number of comments, predominantly regarding the process and transparency, that we think will make the *ex post* testing more effective in ensuring compliance.

- Ofcom in its proposal says that it will conduct a 'high level assessment' based on data BT provides (§4.81). We are unsure what 'high level assessment' means – Ofcom does not explain what it means in its consultation. We believe that once the data has been submitted to Ofcom, Ofcom should quickly determine whether there is sufficient evidence to suspect that BT may have breached the SMP condition. This will require a review/scrutiny of the raw data that BT provides (to check for anomalies etc), inputting this into a model that tests for margin squeeze and reaching a result. If there is a margin squeeze or close to a margin squeeze (say within £1) then Ofcom should open a formal investigation on an expedited basis. In its VULA Margin Statement Ofcom should outline the process and steps that it will follow when it receives data form BT – this will improve transparency and certainty for all stakeholders. We remain very concerned that [✂]. With this in mind,

[102] It is worth noting that if BT restructured its packages then the nature of the product groups may need to change. Obviously BT will know about this well in advance and so should inform Ofcom so that Ofcom can provide new guidance if necessary. Guidance might also need to be updated in the case that Openreach restructured its wholesale charges e.g. introducing a throughput charge or volume discounts.

we would argue that the information submitted by BT every six months must be [✂]. BT will have an obvious incentive to [✂]. Ofcom must also give due consideration to whether it would be possible to invoke its powers under Section 98 to deal with urgent cases given that a continued margin squeeze would result in "serious economic problems" for other communications providers.

- When Ofcom has reached its 'decision' about what it will do (e.g. not pursuing any further review) then it should publicise this. This will be consistent with Ofcom's regulatory principles – "*Ofcom will strive to ensure its interventions will be … transparent in both deliberation and outcome*". It will also allow other CPs to decide on what course of action they may wish to take (for instance submit a formal dispute or complaint). If Ofcom is 'silent' (and CPs in the dark) about the point Ofcom has reached it is likely to create uncertainty and elicit unnecessary complaints
- The data that BT provides must be audited to detect errors and assure the data. Without an external audit [✂]. Ofcom has provided[103] two reasons for why it does not think an external audit is appropriate – we do not think these justify no audit requirement
  - The first reason is that there will be an external audit of some of the BT's data through the statutory reporting requirement . This is an unsound reason. Firstly, the statutory audit only assures high level revenues and costs that is not at the level of detail that is required for margin test submission. Thus much of the data that is provided to Ofcom will be unaudited (for instance the allocation of costs between copper and fibre products). Secondly the audited data will not be available until significantly after the margin test submission[104]. The absence of audit will provide a straightforward opportunity for BT to manipulate the data in its favour.
  - The second reason is requiring an external audit will delay the submission. There is no need for the external audit to delay submission. BT can make (within a month of period end) an initial submission based on unaudited data. Ofcom can margin test this and then when the audit is complete, BT can provide another submission based on audited data. That way Ofcom is able to get a quick result on 'first-cut' data and then get a more robust result later. The data provided for margin testing is as important as BT's regulatory financial reports and [✂] – thus it makes no sense to require no audit for margin test data whilst requiring it for regulatory financial reports.

  That the data will ultimately be audited and submitted to Ofcom will greatly increase BT's incentives not to manipulate the data it provides to Ofcom.

[103] FAMR: Approach to the VULA margin §4.111

[104] The margin test submission will be on 30 April (for previous October to March) and 30 October (for previous April to September). The statutory audit report is probably not available until May each year. Thus data which is audited would only be available 1 month after the 30 April submission and 7 months after the 30 October submission

- In order that Ofcom can conduct its test quickly BT must provide data in the necessary format and definition. Ofcom should require that BT provides the data in the necessary way
- More generally [✂].

7.3 Pre-launch test filing

7.9 We consider that Ofcom should require BT to file a margin test for material new products launches and or material price changes[105] as a <u>complement</u> to *ex post* testing[106]. This will have a number of benefits:

- reduce the possibility of non-compliant products being offered to customers and harm being caused to competition and consumers;
- reduce [✂]. If the pre-launch tests showed that [✂].

7.10 Ofcom raised a concern[107] that in the case of pre-launch testing Ofcom would need to 'scrutinise' the BT submission to some degree. We think that this concern is misplaced. There is, as far as we are aware, no statutory duty or regulatory obligation to review or scrutinise submissions Ofcom is given and nor do we think that it would be poor regulatory practice.

7.11 In light of this, we do not think that any of the concerns that Ofcom raised about pre-launch testing are material:

- The burden on BT will be limited since BT should anyway be conducting compliance checks on new products and price changes (and should be using Ofcom's model to do these) and such checks will require forecasts to be made. The filing obligation will merely require the submission of this to Ofcom;
- Excessive regulatory burden can be avoided by only requiring the pre-launch test on material new product launches and price changes that result in (say) a £1 reduction in revenues or increase in costs; and,
- We accept that any pre-launch test will rely to some degree on forecasts (e.g. on future unit costs estimates) and therefore [✂]. However, we think that

[105] The pre-launch test required will need to reflect the nature of the test being applied e.g. whether product-by-product tests are imposed. Pre-launch testing would be easiest on product groups at LRIC+ though pre-launch test could also easily be done for both a portfolio and product groups at LRIC+.

[106] Ofcom seems to suggest that if there was pre-launch test filings then they would be <u>instead</u> of *ex post* testing (FAMR: Approach to the VULA margin §7.44). This is neither what TalkTalk is suggesting and nor is it necessary or appropriate. If there were only pre-launch tests then the regime could be gamed by BT launching based on one set of revenue/costs (that did not margin squeeze) and then amending these to create a squeeze e.g. by reducing prices, increasing discounts, raising wholesale charges, adding more features/costs, increasing marketing etc. Similarly at §7.40 Ofcom says: "*As we propose to undertake the assessment on BT's entire superfast portfolio this enables the review of all BT's products on a regular basis, rather than being contingent on individual product launches.*" This also indicates that Ofcom sees (wrongly) pre-launch testing as an alternative to ex post testing

[107] FAMR: Approach to the VULA margin footnote 153

the ability for gaming is limited since the range of plausible forecasts is narrow[108] and it is better to have some (albeit slightly imperfect) pre-launch test filing than no pre-launch test filing at all. To have no pre-launch test filing would make 'the best the enemy of the good'.

7.12 Such a pre-launch test filing obligation could either be imposed as a systematic obligation or by Ofcom exercising its power to require ad-hoc reporting. We prefer the former systematic mechanism since it is more transparent and predictable. Also, an ad-hoc requirement will result in delay since it will take some time for Ofcom to reach a decision to request more details from BT.

7.13 The absence of any pre-launch tests places the UK behind European practice whereas usually Ofcom is a leading NRA.

7.14 The European Commission recommendation on non-discrimination obligations and costing methodologies[109] in September 2013 the Commission describes how margin tests should be carried out (it refers to these as testing for 'economic replicability'). It refers to products being tested before or soon after launch – for example: "*The procedure that the NRA will follow to conduct an ex ante economic replicability test, specifying that the NRA can start the procedure on its own initiative or at the request of third parties, at any time but no later than three months after the launch of the relevant retail product*". The European Commission also (in April 2013) criticised CNMC[110] for not carrying out pre-launch tests. For instance, it said

> *"In particular, the Commission points out that the recommended test could be carried out at any time but no later than three months after the launch of the relevant retail product and the NRA should conclude it within the shortest possible time and in any case within four months. Accordingly, the Commission urges CMT to revisit the proposed methodology for ex ante tests of commercial offers along the lines of the forthcoming Recommendation"*

7.15 Pre-launch tests are also the 'norm' around Europe. We have reviewed various aspects of NGA regulation in 9 of the main countries in the EU (Austria, Belgium, Denmark, Germany, Greece, Ireland, Italy, Netherlands and Spain). This shows that in 8 of 9 countries they had pre-launch margin tests and in the one instance where they had no pre-launch tests (Belgium) there was a charge control in place[111]. In some of these cases, the level of regulatory intervention by the NRA is significantly greater than we are suggesting – for instance, the NRA checks the margin itself. Ofcom itself notes that other NRAs have more active and pre-emptive approaches to ensuring compliance than it is proposing.

[108] Forecasts will be required for, for example, out of package call usage, bandwidth usage, customer service unit cost but all of these can be based on historic usage/cost levels and trends.
[109] Commission Recommendation on consistent non-discrimination obligations and costing methodologies to promote competition and enhance the broadband investment environment (of 11.9.2013)
[110] Case ES/2013/1433
[111] charge control is referred (rather confusingly) as cost orientation by most other NRAs

7.4 Clarity of fines

7.16 BT will only have a strong incentive to comply with the margin squeeze regulation if they expect to be fined an amount that is greater than the commercial benefit from breaching. If BT do not expect to be fined or expect to be fined only a small amount then it will be more profitable for them to not comply.

7.17 Given therefore the importance of fines in ensuring compliance we were a little surprised that the consultation document had only a cursory mention of fines (in §4.39) and that this mention was only a brief comment that non-compliance can result in penalties and that Ofcom would refer to its existing (generic) guidelines in deciding any fine. Whilst obviously Ofcom cannot fetter its discretion by, for instance, stating the level of a fine, we think that Ofcom can go further than saying as little as it has. In particular we think that Ofcom can and should:

- Highlight that Ofcom would *consider* a fine for a first offence
- Describe the factors that would consider in deciding the level of a fine e.g. magnitude/duration of a breach, how foreseeable breach was (e.g. whether pre-launch tests shows breach)
- Describe the purpose of the fine e.g. that is to create incentive to comply

7.18 We do not think that providing this information in its final statement will in any way fetter Ofcom's discretion but will provide clarity around fining and create expectations that will encourage compliance. Though Ofcom have penalty guidelines[112] these are generic and cover all types of penalties that Ofcom might levy – thus they are not specific to the particular situation here and do not provide a good level of certainty.

7.19 [✂].

7.20 The need for clarity around fines is particularly important given both BT's history of breaching (e.g. providing incorrect information under a s135 request[113], repeatedly late RFS filing) and [✂].

Ofcom has not, it appears, considered what else might happen in the case of a breach – aside of the brief and unspecific mention of penalties. We think that Ofcom should consider (again without fettering its discretion) what remedial steps might be taken in the case of a breach. For instance, in Denmark, in the case that there is a margin squeeze TDC (the incumbent) is required to reduce the wholesale charge in the following period to effectively compensate for the inadequate margin in the previous period. It would also be useful to understand whether Ofcom would grant permission for, in the case of a breach, CPs to pursue damages in court.

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[112] http://www.ofcom.org.uk/about/policies-and-guidelines/penalty-guidelines/

[113] see Ofcom's Competition Bulletin on the BT remittal data request http://stakeholders.ofcom.org.uk/enforcement/competition-bulletins/closed-cases/all-closed-cases/BT-remittal-data-request/