Amendment to the VULA Margin Control

Adoption of revised SMP Services Condition and guidance further to paragraph 2 of the Competition Appeal Tribunal's Directions of 25 July 2016

Non-Confidential Version

Statement

Publication date: 29 July 2016

About this document

In March 2015, Ofcom imposed a price control on British Telecommunications plc (“BT”) to regulate the margin between BT’s wholesale and retail superfast broadband prices (the “VULA margin control”).

BT appealed against both the imposition, and design, of the VULA margin control in May 2015. The Competition Appeal Tribunal (“Tribunal”) dismissed BT’s appeal against the imposition of the VULA margin control in a judgment dated 24 March 2016. Further, in a ruling dated 25 July 2016, the Tribunal dismissed all but one of BT’s challenges to the design of the VULA margin control.

The one challenge upheld by the Tribunal in BT’s appeal was BT’s submission that Ofcom had erred by requiring it to maintain a minimum VULA margin on a month-by-month basis. This document therefore sets out those revisions that Ofcom is making to the VULA margin control and its associated guidance in order to correct the error identified by the Tribunal.

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Section 1

The VULA margin control and the "compliance period"

Introduction

1.1 On 19 March 2015, Ofcom published the statement *Fixed Access Market Reviews: Approach to the VULA margin* (the "March 2015 Statement").[1] In the March 2015 Statement, Ofcom imposed a price control on the supply by British Telecommunication Plc ("BT") of Virtual Unbundled Local Access ("VULA") pursuant to sections 45, 87 and 88 of the Communications Act 2003 (the "2003 Act").[2] This control is referred to in this document as the "VULA margin control".

1.2 The VULA margin control was imposed as a consequence of Ofcom's 2014 review of the wholesale local access market, which identified BT (Openreach) as having significant market power in that market.[3] Ofcom determined that a price control was necessary as a remedy to address the risk of adverse effects for consumers arising from BT's ability and incentive to impose a price squeeze between the price of its wholesale (VULA) and retail superfast broadband services.

1.3 The SMP services condition imposing the VULA margin control is contained in Schedule 1 to the notification at Annex 2 of the March 2015 Statement. Ofcom also issued guidance on its assessment of the VULA margin under the VULA margin control. This guidance is set out at Annex 3 of the March 2015 Statement, and was supplemented by paragraph 2.66 of Ofcom's statement of 13 August 2015 entitled *Supplementary guidance on assessment of the VULA margin* (the "August 2015 Statement").[4]

1.4 The VULA margin control imposed by Ofcom in the March 2015 Statement requires BT to maintain a minimum margin between the price of its wholesale and retail superfast broadband prices.

Price control appeals

1.5 In May 2015, BT brought an appeal against the March 2015 Statement to the Competition Appeal Tribunal ("Tribunal").

1.6 The first ground of appeal raised by BT concerned the imposition, rather than design, of the VULA margin control. This was considered by the Tribunal in December 2015 and, on 24 March 2016, was unanimously dismissed.

1.7 The remainder of BT's grounds of appeal related to the design of the VULA margin control and were, therefore, 'specified price control matters'. As a result, the Tribunal

[1] Available at: http://stakeholders.ofcom.org.uk/consultations/VULA-margin/statement/
[2] VULA provides access to BT's next generation access network. It is used as an input in the retail supply of superfast broadband services.
[3] Available at: http://stakeholders.ofcom.org.uk/telecoms/ga-scheme/specific-conditions-entitlement/market-power/fixed-access-market-reviews-2014/statement/
[4] Available at: http://stakeholders.ofcom.org.uk/binaries/consultations/vula-margin-guidance-supplementary/statement/VULA_margin-supplementary_guidance.pdf

referred these for determination to the Competition & Markets Authority (the "CMA") in January 2016.

1.8 The CMA notified the Tribunal of its determination in respect of the specified price control matters in the BT appeal on 13 June 2016. It determined that, in respect of all but one of the matters referred to it, Ofcom had not erred and therefore that BT's appeal should be dismissed.

1.9 The only matter referred to the CMA in which Ofcom was found to have erred was Ofcom's decision to assess BT's compliance with the VULA margin control on a month-by-month basis (i.e. Reference Question 3(b)).[5]

1.10 The CMA determined that, in order to remedy this error, the compliance period should be extended from one month to six months.[6] It also explained its preference that the six-month compliance periods be based on BT's financial year, namely 1 April to 30 September and 1 October to 31 March.

1.11 By a ruling of 25 July 2016, the Tribunal dismissed each of the grounds of appeal in BT's appeal save for the sub-ground of appeal encapsulated in Reference Question 3(b). On Reference Question 3(b), the Tribunal decided that it is upheld to the extent found in the CMA's determination.

Directions from the Competition Appeal Tribunal to Ofcom

1.12 On 25 July 2016, the Tribunal issued an order which requires Ofcom to correct the error identified by the CMA in Reference Question 3(b) of BT's appeal.

1.13 Ofcom is therefore amending the VULA margin control and its associated guidance in line with the Tribunal's order, with effect from 1 August 2016.

[5] Ofcom's decision to require compliance on a month-by-month basis is reflected in the definition of "*compliance period*" in the VULA margin control. In particular, whilst Ofcom collects the data required to assess BT's compliance with the VULA margin control every six months, the VULA margin control adopted in the 2015 March Statement requires BT's compliance to be analysed for each individual month separately (the compliance period). BT must therefore demonstrate that it earns the required level of margin in each monthly compliance period. Ofcom's guidance on its assessment of the VULA margin explains what data Ofcom will use in order to determine BT's costs and revenues for wholesale and retail superfast broadband in a particular month.

[6] CMA Determination,§8.68. Available at: https://www.gov.uk/cma-cases/superfast-broadband-price-control-appeals-bt-and-talktalk

Section 2

The revised VULA margin control and guidance

2.1 Ofcom is amending the VULA margin control with effect from 1 August 2016 such that BT shall be required to maintain a minimum VULA margin over the following compliance periods:

2.1.1 1 August 2016 to 30 September 2016;[7]

2.1.2 after the period referred to at paragraph 2.1.1 above, the following periods:

a) 1 October to 31 March; and

b) 1 April to 30 September.

Revisions to SMP services condition 14 (VULA margin control)

2.2 With effect from 1 August 2016, the VULA margin control set out at Schedule 1 to the notification at Annex 2 of the March 2015 Statement will be replaced with the condition set out at Annex 1 to this document.

Revisions to accompanying guidance on the VULA margin

2.3 With effect from 1 August 2016, the guidance set out at Annex 3 of the March 2015 Statement (as supplemented by paragraph 2.66 of the August 2015 Statement) will be replaced with the guidance set out at Annex 2 to this document. [8] [9]

[7] The revised version of the VULA margin control provides that, during this compliance period, Ofcom will assess BT's compliance by summing BT's monthly costs and revenues in respect of the period 1 April 2016 to 30 September 2016.

[8] When revising the VULA margin guidance, Ofcom has not followed the paragraph numbering adopted by the Tribunal in Annex B of its direction to Ofcom. In particular, Ofcom has used paragraph numbers commencing 'A3' rather than 'A1' in order to mirror the numbers used in the March 2015 Statement and to ensure that internal cross-referencing remains accurate following the revisions set out in this document.

[9] Ofcom has added the supplementary guidance from its August 2015 Statement as new paragraphs A3.75-A3.77 to the guidance originally set out in Annex 3 of the March 2015 Statement. Whilst most of the revisions made are to give effect to the Tribunal's order of 25 July 2016, Ofcom has also corrected a typo in the version of Guidance Table 1 in Annex 3 where "TSO – direct, indirect and fixed" incorrectly cross-referred to paragraphs 6.168-6.200 of the March 2015 Statement rather than paragraphs 6.198-6.200.

Annex 1

SMP Condition 14 - The revised Virtual Unbundled Local Access margin control

14.1 This condition applies to Virtual Unbundled Local Access provided by the Retail Divisions. Unless OFCOM otherwise consents in writing, the Dominant Provider must set the charge for Virtual Unbundled Local Access provided by the Retail Divisions in accordance with conditions 1 and 2 so that a Minimum Margin is maintained.

14.2 For the purposes of this condition 14, a Minimum Margin is maintained if, during any Compliance Period:

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

Where:

P is the sum of the Projected Monthly Revenue for each month in the applicable Relevant Period. For this purpose, "**Projected Monthly Revenue**" means, in respect of a month in a Relevant Period, the total revenue generated by the Retail Divisions where such revenue is associated with the supply of VULA-Based Broadband Packages to New Subscribers relevant to that month (excluding Upfront Revenue for that month) (the "**Base Revenue**"), as Projected Forward;

W is the sum of the Projected Monthly Charges for each month in the applicable Relevant Period. For this purpose, "**Projected Monthly Charges**" means, in respect of a month in a Relevant Period, the total wholesale charges levied by Openreach for both Virtual Unbundled Local Access and Wholesale Analogue Line Rental for the purpose of the supply of VULA-Based Broadband Packages to New Subscribers by the Retail Divisions relevant to that month (the "**Base Charges**"), as Projected Forward;

DC is the sum of the Projected Monthly Costs for each month in the applicable Relevant Period. For this purpose, "**Projected Monthly Costs**" means, in respect of a month in a Relevant Period, the total long-run incremental costs (including the Relevant Bandwidth Costs) incurred by the Dominant Provider where such costs are associated with the supply of VULA-Based Broadband Packages to New Subscribers by the Retail Divisions relevant to that month (excluding Base Charges and Upfront Costs for that month) plus an appropriate mark up for the recovery of common costs including an appropriate return on capital employed (the "**Base Costs**"), as Projected Forward;

UR is the sum of the Upfront Revenue for each month in the applicable Relevant Period. For this purpose, "**Upfront Revenue**" means, in respect of a month in a Relevant Period, the total revenue generated by the Retail Divisions where such revenue is associated with the acquisition of New Subscribers to VULA-Based Broadband Packages relevant to that month; and

UC is the sum of the Upfront Costs for each month in the applicable Relevant Period. For this purpose, "**Upfront Costs**" means, in respect of a month in a Relevant Period, the total long-run incremental costs incurred by the Retail Divisions where such costs are associated with the acquisition of New Subscribers to VULA-Based Broadband Packages relevant to that month plus an appropriate mark up for the recovery of common costs including an appropriate return on capital employed.

For the purposes of this condition 14.2, any costs, charges or revenue referred to as being Projected Forward shall be calculated by:

(a) dividing the Base Revenue, Base Charges or Base Costs (as applicable) by the number of calendar days in the relevant month (resulting in the "**Daily Average**");

(b) multiplying the Daily Average by 30.4375 (resulting in the "**Monthly Average**"); and

(c) then applying the following formula:

$$\sum_{t=0}^{N} \frac{M_t}{(1+i)^t}$$

Where:

t is a number from 0 to N for each of the N months;

i is the appropriate cost of capital (expressed as a monthly figure), as determined by OFCOM from time to time;

N is 60; and

$\boldsymbol{M_t}$ means the Monthly Average.

14.3 The Dominant Provider must record, maintain and supply to OFCOM in an electronic format (including in any such presentational form or arrangement (including as to the level of disaggregation) as OFCOM may direct from time to time), no later than one month after the end of each Relevant Period, the data necessary for OFCOM to monitor compliance of the Dominant Provider with condition 14.1 above in respect of Virtual Unbundled Local Access. This data must include:

(a) Base Revenue;

(b) Base Charges;

(c) Base Costs;

(d) Upfront Revenue;

(e) Upfront Costs; and

(f) such other data as OFCOM may direct from time to time,

in respect of each month in the preceding Relevant Period and/or such other period as OFCOM may direct from time to time.

14.4 In this condition 14:

(a) "**Base Charges**" has the meaning given to it in condition 14.2;

(b) "**Base Costs**" has the meaning given to it in condition 14.2;

(c) "**Base Revenue**" has the meaning given to it in condition 14.2;

(d) "**Compliance Period**" means:

(i) the period between 1 August 2016 and 30 September 2016; and

(ii) the following periods of six months beginning either (as applicable) on:

a. 1 October and ending on 31 March; and

b. 1 April and ending on 30 September;

(e) “**Daily Average**” has the meaning given to it in condition 14.2(a);

(f) “**enterprise**” shall have the meaning given to it in the Enterprise Act 2002;

(g) “**Enterprise Act 2002**” means the Enterprise Act 2002 (c.40), as amended;

(h) “**Minimum Margin**” has the meaning given to it in condition 14.2;

(i) “**Monthly Average**” has the meaning given to it in condition 14.2(b);

(j) “**New Subscribers**” means, in respect of a month, those end-users that do not subscribe to a VULA-Based Broadband Package as at the commencement of that month;

(k) “**Openreach**” means the access services division of the Dominant Provider established under section 5 of the undertakings given by the Dominant Provider to OFCOM in accordance with section 154 of the Enterprise Act 2002, accepted by OFCOM on 22 September 2005;

(l) “**Plusnet**” means Plusnet Plc, whose registered company number is 03279013;

(m) “**Projected Forward**” has the meaning given to it in condition 14.2;

(n) “**Projected Monthly Charges**” has the meaning given to it in condition 14.2;

(o) “**Projected Monthly Costs**” has the meaning given to it in condition 14.2;

(p) “**Projected Monthly Revenue**” has the meaning given to it in condition 14.2;

(q) "**Regulatory Financial Statement**" shall have the meaning given to it in condition 13A;

(r) “**Relevant Bandwidth Costs**” means, in respect of a month:

(i) where the latest available Regulatory Financial Statement relevant to the month is the 2013/14 RFS, whichever is the higher of either the Dominant Provider's Unit Bandwidth Costs relevant to the month or £9.20 per Mbit/s;

(ii) where the latest available Regulatory Financial Statement relevant to the month is the 2014/15 RFS, whichever is the higher of either the Dominant Provider's Unit Bandwidth Costs relevant to the month or £7.17 per Mbit/s; or

(iii) where the latest available Regulatory Financial Statement relevant to the month is the 2015/16 RFS, whichever is the higher of either the Dominant Provider's Unit Bandwidth Costs relevant to the month or £5.59 per Mbit/s;

(s) "**Relevant Period**" means:

(i) the period between 1 April 2016 and 30 September 2016; and

(ii) after the period referred to in (i) above, the following periods of six months beginning either (as applicable) on:

a. 1 October and ending on 31 March; or

b. 1 April and ending on 30 September;

(t) "**Retail Divisions**" means the enterprise of the Dominant Provider known as 'BT Consumer' (and which includes Plusnet) as at the date of the entry into force of this condition or such other enterprise or enterprises that may replace or succeed BT Consumer from time to time;

(u) "**Unit Bandwidth Costs**" means, in respect of a month, the average cost of providing 1Mbit/s of capacity between the Local Serving Exchange and the internet relevant to that month;

(v) "**Upfront Costs**" has the meaning given to it in condition 14.2;

(w) "**Upfront Revenue**" has the meaning given to it in condition 14.2;

(x) "**VULA-Based Broadband Package**" means any product, service or bundle of products or services (including, but not limited to, telephony (including fixed and mobile telephony) and television services (including content)) offered by the Dominant Provider during the relevant month through its Retail Divisions to New Subscribers which include the provision of a broadband connection, where the Dominant Provider uses Virtual Unbundled Local Access in order to provide that broadband connection;

(y) "**VULA-Based Broadband Packages**" means all products, services or bundles of products or services (including, but not limited to, telephony (including fixed and mobile telephony) and television services (including content)) offered by the Dominant Provider during the relevant month through its Retail Divisions to New Subscribers which include the provision of a broadband connection, where the Dominant Provider uses Virtual Unbundled Local Access in order to provide that broadband connection;

(z) "**2013/14 Financial Year**" means the period 1 April 2013 to 31 March 2014 (inclusive);

(aa) "**2013/14 RFS**" means the Regulatory Financial Statement prepared by the Dominant Provider in relation to the 2013/14 Financial Year;

(bb) "**2014/15 Financial Year**" means the period 1 April 2014 to 31 March 2015 (inclusive);

(cc) "**2014/15 RFS**" means the Regulatory Financial Statement prepared by the Dominant Provider in relation to the 2014/15 Financial Year;

(dd) "**2015/16 Financial Year**" means the period 1 April 2015 to 31 March 2016 (inclusive); and

(ee) "**2015/16 RFS**" means the Regulatory Financial Statement prepared by the Dominant Provider in relation to the 2015/16 Financial Year.

Annex 2

Revised guidance on assessment of the VULA margin

Introduction

A4.1 This Annex sets out guidance on how we intend to undertake an assessment of whether BT is complying with SMP condition 14. This guidance reflects the approach we would take based on the information available to us at this time. However, we recognise that it may be appropriate to depart from this guidance if there is a material change in circumstances.

A4.2 This guidance should be read alongside SMP condition 14.

Structure of this guidance

A4.3 SMP condition 14 distinguishes between the following five categories of monthly costs/revenues:

- Base Revenues;
- Base Charges;
- Base Costs;
- Upfront Costs; and
- Upfront Revenues.

A4.4 Each of these cost and revenue categories are discussed in turn in this guidance at paragraphs A3.15-A3.23 (Base Revenues), A3.24-A3.25 (Base Charges), A3.26-A3.62 (Base Costs), A3.63-A3.72 (Upfront Costs) and A3.73-A3.74 (Upfront Revenues).

A4.5 We first discuss at paragraphs A3.7-A3.14 our general approach to assessing compliance with SMP condition 14.

A4.6 This guidance uses the following terms:

- "**compliance period**": the period from 1 August 2016 to 30 September 2016, and thereafter a period consisting of six consecutive calendar months during which BT must maintain the minimum VULA margin specified in the SMP condition. Compliance is evaluated, in each compliance period, by summing the monthly costs/revenues from a six month period (the applicable Relevant Period as defined in SMP Condition 14).
- "**monthly period**": each individual calendar month within that Relevant Period. In particular, while BT's compliance with SMP condition 14 will be assessed by looking at its margin across a six-month period, Ofcom will collect cost and revenue data from BT in relation to each monthly period. Further, each of the five categories of monthly revenues/costs referred to at A3.3 above (and on which

this document provides guidance) are intended to capture BT's costs and revenues across monthly periods.

- "**data period**": a period from which we take cost and revenue data to assess the VULA margin. Note that some of the data used to assess compliance may come from the months outside the compliance period, e.g. most recent full financial year (this is explained in further detail below).

Overview of approach

A4.7 Except where noted otherwise, we would assume that the VULA margin was constant over the Average Customer Lifetime ('ACL').

A4.8 When conducting an assessment, we would consider whether a material change in circumstances occurred in the months preceding or during the compliance period. If there was evidence that this was the case then we may depart from the guidance set out below.

A4.9 When assessing BT's compliance with SMP condition 14 during a particular time period, we would seek to use historical data that is representative of the circumstances over the ACL.

A4.10 In order to assess BT's fibre portfolio, we would calculate weighted average revenues and costs across individual bundles within BT's fibre portfolio. The weights used in the calculation would be the volumes of subscribers acquired on each product during the monthly period.

A4.11 When carrying out an assessment of the VULA margin, we would simplify our modelling in order to focus on the most material factors. In particular we would:

- not specifically take fibre to the premises (FTTP) bundles into account when carrying out modelling; and

- analyse Plusnet subscribers by using data on the costs and revenues for superfast broadband products supplied by the rest of BT Consumer, except where data on Plusnet's specific costs and revenues can be easily sourced using publicly available information or Plusnet's management accounts.

A4.12 When assessing the VULA margin we would consider the prices that BT charges to new superfast broadband customers.

A4.13 The VULA margin assessment would include the costs and revenues of any new services BT begins to bundle with superfast broadband during the market review period (e.g. mobile services).

A4.14 We would use the pre-tax nominal weighted average cost of capital ('WACC') relevant to the BT Consumer business prevailing in the monthly period in order to project forward BT's Base Costs, Base Charges and Base Revenues.

Base Revenues

A4.15 Our guidance on how we would calculate Base Revenues in respect of a monthly period is set out in the following subsection.

Monthly subscription revenues

A4.16 Headline monthly subscription prices for the product tiers in the superfast broadband portfolio would be the prices applicable during the monthly period. We would make an adjustment to the headline monthly subscription prices to take into account loyalty / retention discounts which BT offers to certain customers. The level of the adjustments would be estimated by calculating the average percentage discount given on each product tier over the monthly period.

Line rental revenues

A4.17 Line rental prices would be the line rental prices applicable during the monthly period. To take into account the different prices of standard line rental and annual line rental saver, the average line rental price would be estimated on the basis of the volumes of BT superfast broadband customers using each option over the monthly period.

Call revenues

A4.18 The call revenues earned from a superfast broadband customer would be sourced from BT's database[10] and would be based on the average revenues earned from superfast broadband customers over the previous six months. This would include revenues earned from package fees and out of package ('OOP') calls.

Out of package data usage revenues

A4.19 The OOP data usage revenues earned from a superfast broadband customer would be sourced from BT's system[11] and would use the average OOP data usage earned from superfast broadband customers over the previous six months.

Advertising revenues

A4.20 We would estimate the amount of advertising revenue earned from a superfast broadband customer by taking the amount recorded in the most recent annual Broadband management accounts and dividing by the average broadband customer base over the period the accounts cover and converting to a monthly figure.

TV revenues

A4.21 The headline monthly subscription prices for BT TV would be the prices applicable during the monthly period.

A4.22 We would estimate on-demand revenues by taking the total on-demand revenues reported in the most recent BT TV management accounts and dividing by the average number of TV subscriptions in the period covered by the accounts and converting to a monthly figure.

A4.23 We would adjust ongoing TV revenues downwards to account for those triple-play superfast broadband customers who cease taking BT TV before the 5-year

[10] BT currently holds a database, known as [✂], which collects the calling records of each of its customers' accounts and includes information on the pence per minute call charges and costs applicable in a given month (by call type, time of day and package).
[11] Currently known as [✂].

superfast broadband ACL has concluded. We would reduce ongoing TV revenues by [✂] per cent after the first [✂] months of the ACL (i.e. assume that [✂] per cent of triple-play customers continue to receive BT TV for the remaining [✂] months of the ACL). We would revisit this figure in the event that more accurate evidence was available.

Base Charges

A4.24 Our guidance on how we would calculate Base Charges in respect of a monthly period is set out in the following subsection.

A4.25 When assessing the VULA margin we would take the wholesale charges applicable during the monthly period (including volume discounts) published on the Openreach website.

Base Costs

A4.26 Our guidance on how we would calculate Base Costs in respect of a monthly period is set out in the following subsection.

Voice costs

A4.27 The call costs of serving a superfast broadband customer would be sourced from BT's database[12] and would be based on the average calls made by superfast broadband customers over the previous six months. This would cover both in-package and OOP calls and would include product unit costs, payments to other licensed operators and the call costs will be based on the revenues for call types for which costs are not available in the BT's database (e.g. 0844, 0870, premium rate and directory enquiry calls).

Network costs

A4.28 We would estimate network costs using the following approach:

Network costs = Unit bandwidth cost x Average capacity available to each end user

A4.29 We would estimate BT's unit bandwidth cost of supplying superfast broadband services on the basis of the WBC Bandwidth unit FAC in Market 3/Market B according to the regulatory financial system used to prepare the most recent annual RFS at the time of the assessment.

A4.30 Insofar as not already reflected in the RFS methodology, we would make a downward adjustment to accurately reflect the lower backhaul costs of superfast broadband services. The adjustment would be to remove the EAD element of the EoI unit charge in Market 3/B.

A4.31 Insofar as not already reflected in the RFS methodology, we would separately include the cost of MSILs and Cable Links used as transmission bearers. Transmission bearer costs would be calculated by multiplying the prices charged by BT Wholesale (for MSILs) and Openreach (for Cable Links) by the total number of links used to support broadband traffic.

[12] See footnote to paragraph A3.18.

A4.32 Insofar as not already reflected in the RFS methodology, we would separately include the cost of 21CN core transmission. We would calculate the amount of 21CN core transmission costs to include in the unit bandwidth cost by dividing the total FAC (including a return on mean capital employed) of the components that cover transmission on the 21CN core network (currently component CN906) by the total bandwidth volumes of the services that use 21CN core transmission.

A4.33 Insofar as not already reflected in the 2014/15 RFS methodology, we would include in the unit bandwidth cost an appropriate allocation of costs that had previously been allocated on a future benefits basis. We would also consider whether any equivalent adjustment should be made to BT's 2013/14 RFS.

A4.34 If there are any future policy decisions affecting the calculation of BT's unit bandwidth costs within its RFS, we would take these into account at the point from which any decisions are made.

A4.35 We would use the average capacity available to each user for each product in the superfast broadband portfolio covering the same time period as the unit bandwidth cost data relates to.

Network rental overheads

A4.36 To avoid the double-counting of selling, general and administration (SG&A) costs, we will not include a separate network rental overheads item in the VULA margin assessment.

Platform and portal fees

A4.37 We would estimate the platform costs of serving a superfast broadband customer by allocating the amount recorded in the most recent annual Broadband management accounts in proportion to the total capacity used by customers on each superfast broadband product during the same period (and converting to a monthly figure).

A4.38 We would estimate the portal fees of serving a superfast broadband customer by taking the amount recorded in the most recent annual Broadband management accounts and dividing by the average broadband customer base during the same period (and converting to a monthly figure).

Product feature costs

A4.39 To calculate the cost of providing NetProtect Plus to superfast broadband customers, we would multiply licence charge [✂] by the proportion of new superfast broadband customers who take up this product feature during the previous six months.

A4.40 To calculate the cost of providing BT Cloud to superfast broadband customers, we would multiply the monthly licence fee by the proportion of new superfast broadband customers who take up this product feature during the previous six months.

A4.41 While we include BT Wi-Fi in the VULA margin assessment, we would assume that the costs of the service are zero.

A4.42 We would not include a separate item for SmartTalk costs.

Fibre development costs

A4.43 To estimate the fibre development cost of acquiring a superfast broadband customer, we would take the development spend incurred before the launch of BT's superfast broadband products and divide by the total base of BT superfast broadband customers for the monthly period.

Ongoing SG&A costs

A4.44 We would take each of the SG&A costs in Guidance Table 1 into account when assessing the VULA margin.

Guidance Table 1 – Ongoing SG&A costs

Cost item	Cost type	Description
Marketing – retention	Short-run variable	[✂]
Customer services – ongoing	Short-run variable	[✂]
Billing & bad debt	Short-run variable	[✂]
Total Labour Cost – retention	Short-run variable	[✂]
Total Labour Cost – management	Short-run variable	[✂]
Development	Short-run variable	[✂]
Marketing – non-campaign	Long-run variable/Fixed	[✂]
Customer services – overheads	Long-run variable/Fixed	[✂]
Accommodation	Long-run variable/Fixed	[✂]
Other internal/external spend/recoveries	Long-run variable/Fixed	[✂]
People related costs	Long-run variable/Fixed	[✂]
IT spend	Long-run variable/Fixed	[✂]
Marketing platform spend	Long-run variable/Fixed	[✂]
TSO – direct, indirect and fixed	Long-run variable/Fixed	See explanation in paragraphs 6.198 to 6.200.
Miscellaneous costs	Long-run variable	

A4.45 For short-run variable SG&A costs, we would use either the Customer or Product approaches depending on whether the cost item is principally driven by the number of customers being served or the number of products being sold.

A4.46 For long-run variable or fixed and common SGA costs, we would use the Revenue approach to allocate costs to the superfast broadband portfolio.

A4.47 Guidance Table 2 sets out the allocation approach we would apply to each ongoing SG&A cost item to allocate to the superfast broadband portfolio stack. Once we have calculated the appropriate allocation to the fibre portfolio, we would then calculate the ongoing monthly SG&A cost per superfast broadband customer by dividing the amount allocated by the average base of superfast broadband customers during the data period and converting this to a monthly figure.

Guidance Table 2: Allocation approaches applied to SG&A costs

SG&A cost category	Allocation method
Marketing – retention	Customer
Customer services - ongoing	BT breakdown
Billing & bad debt	Customer
Total Labour Cost – retention	Customer
Total Labour Cost - management	Product
Development	BT breakdown
Marketing – non-campaign	Revenue
Customer services - overheads	Revenue
Accommodation	Revenue
Other internal/external spend/recoveries	Revenue
People related costs	Revenue
IT spend	Revenue
Marketing platform spend	Revenue
Miscellaneous costs	Revenue
TSO – direct and indirect	Revenue
TSO Fixed	Revenue

Ongoing TV costs

A4.48 We would estimate content and bandwidth costs of serving a triple-play superfast broadband customer by taking the amounts reported in the most recent BT TV management accounts for each BT TV package (Essentials package, Essentials Extra package) and dividing by the number of subscribers on each TV package during the period covered by the accounts. Average content and bandwidth costs per superfast broadband customer would be calculated by weighting on the basis of the number of customers on each TV package in the data period.

A4.49 We would estimate licences, customer premise equipment and fixed costs by taking the amounts reported in the most recent annual BT TV management accounts and dividing by the total TV subscribers during the period covered by the accounts.

A4.50 We would adjust ongoing TV costs downwards to account for those triple-play superfast broadband customers who cease taking BT TV before the 5-year superfast broadband ACL has concluded. We would reduce ongoing TV costs by [✂] per cent after the first [✂] months of the ACL (i.e. assume that [✂] per cent of triple-play customers continue to receive BT TV for the remaining [✂] months of the ACL). We would revisit this figure in the event that more accurate evidence was available.

Treatment of BT Sport costs

Calculation of the net costs of BT Sport

A4.51 We would use BT's actually incurred costs in the six months up to and including the monthly period as set out in its accounts for ongoing costs.

A4.52 We would calculate BT's monthly costs for each sport right by converting its actual expenditure on each sports right into a constant monthly payment. We would do this by calculating the NPV of each sports rights contract over the entire contract duration up until the next contract is available (based on each contract's start date) and convert this into an equivalent ongoing monthly cost equal to that NPV. We would use the pre-tax nominal WACC relevant to the BT Consumer business prevailing during the monthly period when carrying out this calculation.

A4.53 We would then take an average of the monthly rights cost across the six months up to and including the monthly period.

A4.54 We would include an additional [✂]/month until March 2018 to reflect the initial launch costs of BT Sport. In the event that a more up to date estimate of the WACC is available, we would consider whether to update this figure.

A4.55 We would likely adjust the total costs of BT Sport to smooth the UEFA launch costs in 2015/16. We would expect BT to provide suitable evidence on the level of these UEFA launch costs. We are unlikely to accept that the level of these costs is higher than [✂] uplifted for CPI inflation since 2013/14.

A4.56 We would likely spread the UEFA launch costs over five years by converting them into an equivalent ongoing monthly cost with a NPV equal to the cost incurred. In calculating that NPV we would likely assume that the discount rate is equal to the monthly pre-tax nominal WACC relevant to the BT Consumer business prevailing during the monthly period.

A4.57 In assessing the direct revenues associated with BT Sport, we would take into account BT's monthly subscription revenues from residential subscribers and commercial premises as well as BT's monthly sublicensing revenues, advertising revenues and provisioning revenues.

A4.58 We would use historical, audited data covering the six months up to and including the monthly period. We would assume that the direct revenues over the ACL are:

- at their level as at the end of that six months, where evidence shows that revenues were growing over those six months; and
- at the historical average over those six months, where evidence shows that revenues were not growing over those six months.

A4.59 In the absence of better information, we would smooth the provisioning revenues over a period of five years using the pre-tax nominal WACC relevant to the BT Consumer business prevailing in the monthly period. We would do this by converting them into constant ongoing monthly revenue with an equivalent NPV.

<u>Allocating the net costs of BT Sport between to superfast broadband</u>

A4.60 When allocating the net costs of BT Sport to BT's superfast broadband portfolio, we would adopt the following two step approach.

A4.61 First we would calculate the total number of BT residential broadband subscribers that (i) have an active BT Sport connection (i.e. they meet the requirements to watch these channels without taking further action); and (ii) pay a discounted price for BT Sport (relative to non-BT broadband subscribers) or receive it for 'free'. We would use whatever proportion of that total is accounted for by superfast broadband subscribers to determine the proportion of the net costs of BT Sport that are allocated to superfast broadband subscribers. Should BT change the terms under which BT broadband customers can watch BT Sport in a way that we consider manipulates our measure of the take-up of BT Sport, we would reconsider our approach to calculating the proportion used to allocate the net costs of BT Sport.

A4.62 Second, we would calculate the net BT Sport cost per superfast broadband customer by dividing the net costs of BT Sport allocated to BT's superfast broadband portfolio by the total number of BT Consumer Infinity and Plusnet Fibre customers during the monthly period.

Upfront Costs

A4.63 Our guidance on how we would calculate Upfront Costs in respect of a monthly period is set out in the following subsection.

Connection costs

A4.64 We would take into account the costs of GEA Connection, GEA Managed Install, WLR Connection (or any future equivalents) and retail-level connection activities.

- GEA Connection charges and GEA Managed Install charges would be the charges applicable during the previous six months.
- To estimate the WLR Connection cost, we would firstly calculate the proportion of connections that incur Openreach charges based on the volumes of superfast broadband customers that were acquired from other operators in the previous six months. We would then calculate the average charge paid for these connections applicable during the previous six months on the basis of the split of acquired customers that required a new line and those that needed an existing line to be migrated using data from BT's management information system.[13]
- Retail-level activity costs would be estimated using the most recent data available from BT's regulatory financial reporting system.[14]

SG&A costs (upfront acquisition)

A4.65 Guidance Table 3 sets out the upfront acquisition SG&A costs that we would take into account.

A4.66 For upfront acquisition SG&A costs, we would allocate on the basis of the number of superfast broadband customers acquired as a percentage of the total number of

[13] Currently known as [✂].
[14] [✂].

customers acquired by BT Consumer during the data period. For example, if a third of all BT Consumer customer acquisitions are for superfast broadband products, we would allocate a third of the total SG&A upfront acquisition costs to the superfast broadband portfolio cost stack. To calculate acquisition SG&A costs per superfast broadband customer, we would then divide this figure by the number of superfast broadband customers acquired during the data period.

Guidance Table 3 –SG&A upfront acquisition costs

Cost item	Description
Marketing – acquisition	[✂]
Affiliates / pay-per-click	[✂]
Customer services - upfront	[✂]

Sales costs

A4.67 We would source sales costs from BT's most recent system[15] which provides a breakdown of the various activities [✂]. The sales costs to be allocated to the superfast broadband portfolio would be estimated by multiplying the proportion of staff time used to acquire superfast broadband customers by the total labour cost of such staff time. To calculate sales costs per superfast broadband customer acquired, we would then divide this figure by the number of superfast broadband customers acquired during the data period.

Voucher costs

A4.68 To calculate the cost of vouchers used for the purposes of acquiring a superfast broadband customer, we would take BT's spend on vouchers during the previous six months and divide this by the number of superfast broadband customers BT acquired during this period.

Discount costs

A4.69 We would treat several months' discount to the monthly subscription prices for newly acquired superfast broadband customers as an upfront cost by multiplying the amount of the discount by the number of months during which it applies. When assessing the VULA margin, we would use the discounts that applied to each product tier during the monthly period.

Router costs

A4.70 We would source the router cost related to the acquisition of a superfast broadband customer from the unit price as set out in the contract BT has agreed with its supplier. We would not include the cost of delivery of the router, as this would be covered by an equivalent postage and packaging charge received from new customers.

[15] Currently known as [✂].

Event charges

A4.71 We would include the following event charges in the Upfront Costs stack.

- BT Expedites – a charge payable to Openreach to carry out the customer installation more quickly than is standard. We would calculate the BT Expedite cost of acquiring a superfast broadband customer by taking the spend on expedites for superfast broadband products over the previous six months and divide this by the number of superfast broadband customers acquired during this period.

- BT Abortive Visits – a charge payable to Openreach when an engineer visit is unsuccessful due to not being able to access the customer's property. We would calculate the BT Abortive Visits cost of acquiring a superfast broadband customer by multiplying the abortive visits charge by the percentage of superfast broadband customers acquired who had an abortive visit over the previous six months.

- Modify upstream order charges – a charge payable to Openreach to cancel, amend or modify a customer order. We would calculate the Modify upstream order charge cost of acquiring a superfast broadband customer by multiplying the modify order charge by the percentage of superfast broadband customers acquired who had an order cancelled or amended over the previous six months.

- SFI and TRC – charges payable to Openreach to cover the cost of engineers investigating and repairing faults on the Openreach network. We would calculate the average SFI and TRC costs incurred to serve a superfast broadband customer by (i) multiplying the total payments BT Consumer made to Openreach for these services during the previous six months by the percentage of BT Consumer lines that were taken by superfast broadband customers during this period; and (ii) dividing this figure by the average superfast broadband customer base over the previous six months and converting to a monthly figure.

Upfront TV costs

A4.72 We would take the following upfront TV costs into account when assessing the VULA margin.

- YouView box – superfast broadband customers who sign-up to BT TV are provided with a YouView set-top box at no extra charge. We would source the YouView box cost to be included in the superfast broadband portfolio cost stack from the contract BT has agreed with its supplier.

- Other connection costs – there are a number of connection costs BT incurs when connecting customers with its TV service, including [✂]. We would estimate the other connection costs to include in the superfast broadband portfolio cost stack by taking the amount recorded in the most recent annual BT TV management accounts and dividing by the number of TV additions during the period covered by the accounts.

Upfront Revenues

A4.73 Our guidance on how we would calculate Upfront Revenues in respect of a monthly period is set out in the following subsection.

A4.74 We would use the connection revenues applicable during the monthly period.

Supplementary guidance issued on 13 August 2015

A4.75 During the August 2015 to July 2016 (inclusive) monthly periods ('the Deferral Period'), we would assess the VULA margin in accordance with the rest of our guidance except that the incremental costs and revenues associated with the UEFA Channels (BT Sport 2, BT Sport Europe and ESPN) are excluded.

A4.76 During the August 2016 to April 2017 (inclusive) monthly periods ('the Recovery Period'), we would assess the VULA margin in accordance with the rest of our guidance, including the incremental costs and revenues associated with the UEFA Channels, but with an adjustment to reflect the Total Shortfall.

A4.77 The adjustment to reflect the Total Shortfall would be calculated as follows.

- For each monthly period during the Deferral Period, we would calculate (in £m) the increase or decrease in the net cost of BT Sport allocated to superfast broadband subscribers that would result in Projected Monthly Revenue plus Upfront Revenue being equal to Projected Monthly Charges plus Projected Monthly Costs plus Upfront Costs under the approach set out in the rest of our guidance.

- The Total Shortfall at the end of the Deferral Period (in £m) is the sum of the NPV of all those monthly decreases less the sum of the NPV of all those monthly increases. A Total Shortfall exists if the monthly decreases outweigh the monthly increases.

- At the start of any monthly period during the Recovery Period, if there is a Total Shortfall then we would calculate what monthly £m amount has, over the remainder of the Recovery Period, the same NPV as the Total Shortfall. During that monthly period that monthly £m amount would be added to the £m net cost of BT Sport allocated to superfast broadband subscribers. At the end of that monthly period we would calculate (in £m) the increase in the net cost of BT Sport allocated to superfast broadband subscribers that would result in Projected Monthly Revenue plus Upfront Revenue being equal to Projected Monthly Charges plus Projected Monthly Costs plus Upfront Costs under the approach set out in the rest of our guidance. That amount would be deducted from the Total Shortfall to give a new figure from the Total Shortfall that is used in the next monthly period.

- If no Total Shortfall exists during any monthly period in the Recovery Period (either because no shortfall was accumulated during the Deferral Period or because an amount equal to or greater than any shortfall has been recouped earlier in the Recovery Period) then no adjustment is made.

- The discount rate used in this calculation would be equal to the monthly pre-tax nominal WACC relevant to the BT Consumer business prevailing in the monthly period.