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Office of Communications (Ofcom)
Riverside House — 2a Southwark
Bridge Road
SE1 9HA London
United Kingdom

For the attention of:
Mr Stephen Unger
(Acting) Chief Executive Officer

Fax: +44 20 7981 3504

Dear Mr Unger,

Subject: **Commission Decision concerning Case UK/2015/1692: Wholesale local access at a fixed location in the United Kingdom — Remedies**

Comments pursuant to Article 7(3) of Directive 2002/21/EC

1. PROCEDURE

On 15 January 2015, the Commission registered a notification from the UK national regulatory authority, the Office of Communications (Ofcom),[1] concerning the market for wholesale local access at a fixed location[2] in the United Kingdom.

The national consultation[3] ran from 19 June to 28 August 2014.

On 27 January 2015, a request for information[4] was sent to Ofcom and a response was received on 30 January 2015.

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1 Under Article 7 of Directive 2002/21/EC of the European Parliament and of the Council of 7 March 2002 on a common regulatory framework for electronic communications networks and services (Framework Directive), OJ L 108, 24.4.2002, p. 33, as amended by Directive 2009/140/EC, OJ L 337, 18.12.2009, p. 37, and Regulation (EC) No 544/2009, OJ L 167, 29.6.2009, p. 12.

2 Corresponding to Market 3a in Commission Recommendation 2014/710/EU of 9 October 2014 on relevant product and service markets within the electronic communications sector susceptible to ex ante regulation in accordance with Directive 2002/21/EC of the European Parliament and of the Council on a common regulatory framework for electronic communications networks and services (Recommendation on Relevant Markets), OJ L 295, 11.10.2014, p. 79.

3 In accordance with Article 6 of the Framework Directive.

Pursuant to Article 7(3) of the Framework Directive, national regulatory authorities (NRAs), the Body of European Regulators for Electronic Communications (BEREC) and the Commission may make comments on notified draft measures to the NRA concerned.

2. DESCRIPTION OF THE DRAFT MEASURE

2.1. Background

In 2010 Ofcom notified to the Commission[5] its second review of the market for wholesale local access (WLA) in the United Kingdom, comprising traditional copper loops, cable connections[6] and fibre-based local access. Furthermore, on the basis of the substitution analysis and the need to secure adequate competition on the retail broadband markets, Ofcom included in the market a virtual unbundled local access (VULA) product. Ofcom concluded that the VULA product offers features similar to physical unbundling.[7]

With regard to Local Loop Unbundling (LLU), Ofcom proposed to maintain the previously imposed charge control obligation. For VULA it allowed pricing flexibility (including geographic variations, volume discounts and tiered pricing), while ensuring that VULA is provided on an equivalence of input basis (EoI), i.e. on the same timescales, terms and conditions (including price and service levels), by means of the same systems and processes and by providing the same information as to its own downstream divisions. No VULA-specific margin squeeze test was proposed at the time.

In 2014, Ofcom notified to the Commission its third round review of the wholesale local access market.[8] In line with its previous market review, Ofcom defined the relevant WLA market as including copper-based, cable-based and fibre-based local access at a fixed location. Ofcom did not distinguish between WLA used to provide business or residential services. Similarly, as in its previous market review, Ofcom considered that because of the retail competition between copper-based and cable-based services, at the wholesale level the cable networks exert indirect constraint on the provision of wholesale local access by a network that uses copper/fibre lines.

Ofcom defined two distinct geographic WLA markets: (i) the UK excluding the Hull area and (ii) the Hull area,[9] and designated KCOM with SMP in Hull and BT with SMP in the rest of the UK. With regard to BT's SMP position, Ofcom analysed

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4 In accordance with Article 5(2) of the Framework Directive.

5 See case UK/2010/1064, C(2010) 3615.

6 Ofcom proposes to include cable-based services within the relevant market on the basis of indirect constraints, relying on the evidence available from previous reviews.

7 The key characteristics for VULA are: Local (interconnection should occur locally); Service-agnostic (should be able to support a multitude of services); Uncontended (dedicated capacity should be available to the end-user); Control of access (sufficient control of the access connection should be available); and Control of customer premises equipment (CPE) (sufficient control of CPE should be available).

8 See case UK/2014/1606, C(2014) 4296 final.

9 'The Hull area' refers to Kingston upon Hull and covers 0.7 % of UK premises.

the following main criteria: (i) high and stable market shares;[10] (ii) barriers to entry; and (iii) countervailing buying power.

Ofcom maintained the set of previously imposed remedies for both BT and KCOM. For BT this includes the requirement to provide network access on an EoI basis. Regarding copper based LLU, Ofcom maintained a charge control obligation covering the period up to 31 March 2017. The charge control is based on a top-down cost model.[11]

In the case of the VULA product, Ofcom continued to allow pricing flexibility to BT, e.g. geographic variations, volume discounts and tiered pricing and refrained from imposing a charge control. However, BT is required to provide VULA to access seekers on an Equivalence of Input (EoI) basis, Due to concerns that BT may be incentivised to use this relative pricing freedom inappropriately in order to distort competition in the broadband market and, taking utmost account of the Commission's 2013 Costing and Non-Discrimination Recommendation,[12] Ofcom stated it would consider applying an economic replicability test (ERT) to ensure that BT does not abuse pricing flexibility in order to exclude (potential) competitors from the relevant broadband market.[13] The details of this test, however, were not part of the draft measures notified in 2014.

2.2. The proposed measure

The present notification contains Ofcom's draft decision concerning the VULA margin, and a general prohibition to set VULA charges at a level leading to a margin squeeze. Ofcom's proposed approach covers the current 2014 – 2017 market review period. The proposal is aimed at addressing the risk identified in its 2014 market review, i.e. that competition for superfast broadband could be dampened were BT to use its relative pricing freedom anti-competitively.[14] Ofcom considered

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[10] According to Ofcom, BT's market share at the time was consistently very high and above 80 %, while in 2009 it was 84 %.

[11] The cost model includes an efficiency target of 5 % per year and the level of engineering costs is increased by 3.9 % to enable Openreach to recover its efficiently incurred costs related to the new Quality of Service remedy. The WACC is set at 8.6 %.

[12] Commission Recommendation of 11 September 2013 on consistent non-discrimination obligations and costing methodologies to promote competition and enhance the broadband investment environment (2013/466/EU) — 'the 2013 Recommendation'; O.J. L251, p.13.

[13] In the past 3 years, BT has been winning a substantial share of VULA-based retail superfast broadband subscribers. Although net adds have slowed down to a degree, BT has been consistently able to gain superfast broadband customers that switched from a third party retailer, with around [… %] of BT's new residential superfast broadband subscribers being described by BT as 'new to BT', meaning they had previously not had a BT broadband or PSTN service. .

[14] Ofcom is of the view that BT's ability and incentive to impose a price squeeze for VULA (as was set out in the 2014 market review) is particularly significant for the coming review period given (i) the transition from standard broadband and the future role of superfast broadband (and VULA) and (ii) that the forthcoming market review period is likely to be a crucial stage in the migration to superfast broadband, and competitive conditions in the future are likely to be significantly affected by developments in this period. This risk of the weakening of *future* competition is also a main factor in leading Ofcom to conclude that *ex post* competition law alone is insufficient to achieve Ofcom's regulatory aim of promoting competition. .

it necessary to ensure that BT cannot use its SMP in the WLA market to set the VULA margin over the current market review period such that it causes retail competition in superfast broadband to be distorted. In particular, Ofcom's draft measure attempts to ensure that BT does not set the VULA margin such that it prevents an operator with slightly higher costs than BT from being able to replicate economically BT's retail superfast broadband offers.

As a result, Ofcom proposes to require BT to set its charge for the VULA product in a way that ensures that a 'minimum VULA margin' (between the wholesale VULA price and retail prices for services that use VULA as an input) is maintained.[15] For this reason Ofcom intends to apply an economic replicability test (ERT), the detailed parameters of which are described below.

Ofcom intends to apply an 'adjusted EEO' conceptual approach for assessing costs and revenues. BT's own costs and revenues form the basis for the ERT, with two adjustments to reflect i) the lower average customer lifetimes (ACL)[16] of alternative operators and ii) lower bandwidth costs of alternative operators. With regard to the relevant cost standard, Ofcom proposes to use a LRIC+ standard to assess BT's costs. In deviation from the 'flagship approach' which is recommended in the Commission's 2013 Recommendation, Ofcom proposes to adopt a <u>portfolio</u> approach, which would take into account BT's entire portfolio of fibre-based packages in the analysis, rather than individual products or bundles. Ofcom considers that it is more appropriate to grant BT additional flexibility to determine the margins on individual products within the portfolio and to spread the relevant common costs flexibly over its range of fibre products.

Under Ofcom's proposal, the ERT will assess the existence of a minimum margin between the wholesale VULA price and retail prices for services that use VULA as an input. In this respect, although broadband may be sold as a stand-alone product, the reality is that it is typically sold bundled with other services.[17] In the specific UK scenario, Ofcom considered it appropriate to include the costs related to premium content (in particular of BT Sports rights) in the assessment of the VULA margin. Ofcom presented evidence that shows that BT's investment in BT Sport is closely

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15 For the purpose of the ERT a 'minimum margin' is maintained if, during any individual assessment period (for the precise period see further below):

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

with P = 'Ongoing monthly revenue'; W = 'Ongoing monthly wholesale charges'; DC = 'Ongoing monthly retail costs (LRIC+)'; UR = 'Upfront customer acquisition revenues' and UC = 'Upfront customer acquisition costs'.

16 Ofcom considers the average ACL for standard broadband subscribers as a proxy for superfast broadband customers, as it considers that current superfast broadband churn data may not reflect the level of churn we might expect in a competitive market. Ofcom does not consider that superfast broadband is so different that we should assume it will have intrinsically higher ACLs. The ACL is set at five years, on the basis of Ofcom's observations of the data available on what an adjusted EEO might reasonably be able to achieve in this review period. .

17 Any such other bundled service may not always necessarily rely on regulated wholesale inputs or even services directly related to the provision of core electronic communications services but may consist of products or services such as free virus protection software, retail vouchers or electronic consumer products. .

linked to its strategy in retail broadband to maintain and grow its superfast broadband customer base. In Ofcom's view, excluding BT Sport from the ERT would leave a 'gap' in the test which would allow BT to set a margin that is insufficient for an (adjusted) EEO to compete profitably against BT's superfast broadband packages, where these are bundled with (free) access to BT Sport.[18]

With regards to the recovery of costs, Ofcom proposes to adopt a static approach for the ERT, i.e. to assess whether the ongoing margin for a particular group of customers at a particular point in time (i.e. customers acquired over the relevant assessment period) is sufficient to recover the net upfront costs (incurred by BT to acquire the new customers) over the average lifetime of those customers, assuming that the ongoing margin remains constant over that customer life time. In Ofcom's view, the relevant assessment period should be six months. BT would be required to provide to Ofcom the data necessary to monitor compliance every six months, so that Ofcom could conduct a high-level assessment of the margin at six month intervals.

Ofcom's assessment of the VULA margin would be based on historical data provided by BT, and would consider whether the net present value of the ongoing monthly margin is sufficient to cover the upfront net costs, which would be amortised over the ACL of 5 years. In its response to the Commission's request for information, Ofcom stated that it did not consider it appropriate to allow BT to set a low VULA margin in the short term on the grounds that it will earn a high VULA margin in the future, i.e. to allow BT to defer the recovery of BT Sport cost in the short term. Ofcom's main argument against such a deferral was that it would be extremely difficult to distinguish whether a particular forecast for the growth in BT's profitability is fully legitimate given that such a growth may also reflect that by allowing an inappropriately low VULA margin to start with, BT is able to distort competition in the short run and strengthen its position in retail superfast broadband provision in the future. However, Ofcom recognises that BT may incur higher costs at the initial stages of investment and intends to reflect this by spreading launch costs for BT Sport over a five year period.

3. COMMENTS

The Commission has examined the notification and the additional information provided by Ofcom and has the following comments:[19]

Ability for BT to recover relevant costs flexibly over a longer time period

The Commission takes note of Ofcom's arguments that absent regulatory intervention BT has the ability and incentive over the period of the ongoing market review to use its SMP in the market for wholesale local access at a fixed location to set the VULA margin such that it imposes a price squeeze and may, thus, distort competition for superfast broadband. The Commission further recognises the

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[18] Ofcom is of the view that BT — whilst free to decide how it most profitably commercialises its investment in sports rights — has chosen to recover such investments by including BT Sport in its retail broadband bundles free of charge, thus foregoing the direct revenues it could have earned from reaching wholesale agreements with other TV providers or attempting to earn direct revenues from retailing the content in isolation. .

[19] In accordance with Article 7(3) of the Framework Directive.

potential importance of bundled offers for the health of retail competition for superfast broadband, leading Ofcom to consider it appropriate to include in principle all bundled elements, in particular the provision of BT Sports, in the calculation for the ERT. In this respect, the Commission takes note of the evidence provided by Ofcom that BT's investment in BT Sport can be seen as part of BT's strategy to, at the very least, retain its current broadband customer base (if not to actively increase it). The Commission notes in particular the specific circumstances of the BT Sports offer, which is offered for free to superfast broadband customers.

At the same time, the Commission also recognises that the considerable costs paid by BT for premium content rights available over BT Sport is a long term investment in a market where BT does not have SMP, where the Regulatory Framework on which is the SMP measure is based does not apply, and in which BT faces strong competition by other players.

With this in mind, the Commission considers that a static period-by-period approach looking at a short time interval (six months) in isolation, unduly limits BT's flexibility to defer the recovery of its costs for BT Sport over a longer period. In this respect the Commission stresses that in Annex II to its 2013 Recommendation the Commission clearly stated that NRAs should evaluate the profitability of the relevant retail products on the basis of a *dynamic multi-period analysis* (such as a discounted cash flow, DCF, approach). An adequate reference period would be the average customer lifetime (ACL). The Commission is clear in its 2013 Recommendation that the ability to recover the relevant costs should be assessed over the entire period, allowing flexibility to defer recovery towards the end of the ACL, with the result that a low margin could be permissible at the beginning of the ACL. According to the Commission's 2013 Recommendation NRAs should annualise the downstream costs according to an appropriate depreciation method that takes account of the economic lifetime of the relevant assets (which can be longer than the ACL). Whilst the Commission recognises that Ofcom is applying a LRIC+ approach and intends to take only into account the annualised proportion of the incremental costs relevant to the period in question, the Commission would like to stress that following the recommended LRIC+ methodology combined with a DCF approach should give additional flexibility to defer the recovery of a proportion of the relevant downstream costs to a period where expected demand is higher. Such a flexible approach is important, for example, in order to allow the SMP operator to build sufficient scale.

In the view of the Commission, Ofcom's proposed approach lacks the necessary flexibility in particular with regards to the treatment of costs for BT Sports. The Commission considers that the proposed static approach unduly limits BT's commercial activity with regards to a market in which it does not have SMP.

Indeed, Ofcom's purpose in designing the test is to address a competitive concern in relation to pricing of a regulated product, i.e. VULA, for which it does not propose a charge control. However, the design of the test proposed by Ofcom may result in BT choosing to address a failed test by changing its behaviour on a market other than the regulated market, for example by increasing retail prices or reducing costs for BT Sports. Given the magnitude of the costs involved, and the uncertainty of future costs and revenues of BT Sports as new rights auctions approach, there is a risk that Ofcom's regulatory intervention would have a significant impact on non-regulated markets, without necessarily affecting the price of the VULA input. Ofcom will therefore have to remain vigilant that the application of the test does not have unintended consequences in markets where the application of ex post competition law would be sufficient, or where BT's SMP in the WLA market does not necessarily play a role.

As a result of the above, the Commission requests Ofcom to re-visit the design of its proposed ERT in its final measure and to ensure that sufficient flexibility is given to BT to recover the considerable costs for BT Sport over a longer time horizon, in particular in light of uncertainties relating to scale and costs of future auctions. The Commission will monitor together with Ofcom the situation with regards to the consequences of the application of the test, particularly with regards to the appropriateness of the responses in the event that the test is not passed.

Pursuant to Article 7(7) of the Framework Directive, Ofcom shall take the utmost account of the comments of other NRAs, BEREC and the Commission and may adopt the resulting draft measure; where it does so, shall communicate it to the Commission.

The Commission's position on this particular notification is without prejudice to any position it may take *vis-à-vis* other notified draft measures.

Pursuant to Point 15 of Recommendation 2008/850/EC[20] the Commission will publish this document on its website. The Commission does not consider the information contained herein to be confidential. You are invited to inform the Commission[21] within three working days following receipt whether you consider that, in accordance with EU and national rules on business confidentiality, this document contains confidential information which you wish to have deleted prior to such publication.[22] You should give reasons for any such request.

Yours sincerely,

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For the Secretary-General,

Jordi AYET PUIGARNAU
Director of the Registry
EUROPEAN COMMISSION

For the Commission,
Robert Madelin
Director-General

[20] Commission Recommendation 2008/850/EC of 15 October 2008 on notifications, time limits and consultations provided for in Article 7 of Directive 2002/21/EC of the European Parliament and of the Council on a common regulatory framework for electronic communications networks and services, OJ L 301, 12.11.2008, p. 23.

[21] Your request should be sent either by email: CNECT-ARTICLE7@ec.europa.eu or by fax: +32 2298 87 82.

[22] The Commission may inform the public of the result of its assessment before the end of this three-day period.