



**RESPONSE BY BRITISH SKY BROADCASTING GROUP PLC
TO OFCOM'S CONSULTATION DOCUMENT "REVIEW OF THE WHOLESALE BROADBAND
ACCESS MARKETS – SECOND CONSULTATION ON MARKET DEFINITION, MARKET POWER
DETERMINATIONS AND REMEDIES"**

EXECUTIVE SUMMARY

1. Ofcom is right to update its market definitions in order to account for LLU operators' latest committed rollout plans but it should not base its assessment of the prospect for further market entry during the lifetime of this market review on the speculative, uncommitted forecasts of these operators.
2. However, Ofcom has failed adequately to demonstrate that the introduction of a 50% BT service share criterion (known as "Option 1") at the boundary of intermediate Market 2 and competitive Market 3 will act as a good proxy for competitive conditions in exchange areas.
3. This is because Ofcom
 - places insufficient weight to the lack of effective constraints on BT;
 - as stated above, places too much store in the uncommitted rollout plans of LLU operators; and
 - Makes errors in its assessment of historic market share trends.
4. In order to address these issues, Ofcom has three alternatives;
 - Revert back to its original market definitions based merely on the number of Primary Operators ("POs") present in an exchange area;
 - Adopt a 40% BT service share criterion at the boundary of Market 2 and Market 3 (known as "Option 2" in Ofcom's consultation); or
 - Introduce a completely new criterion.
5. In the interests of simplicity and expediency and due to the lack of effective constraints on BT where its market share exceeds 40%, we recommend that Ofcom adopts Option 2. This would entail approximately 120 exchanges that would have been in Market 3 under Option 1 instead being within Market 2.

6. In fact, given the characteristics of BT's market power, it is unlikely that a "basis of charges" (cost orientation) remedy alone will be sufficient to stop BT earning monopoly rents in Market 2. As such, we now consider it appropriate for Ofcom to apply its proposed charge control remedy not just in Market 1 but in Market 2 as well.

MARKET DEFINITION

7. In this second review of Wholesale Broadband Access (“WBA”) markets in 2010, Ofcom has changed its geographic market definitions. As a result, approximately 1.5m UK households¹ have been moved into the competitive market (Market 3) from the intermediate market (Market 2) where, as proposed by Ofcom, BT still has significant market power (“SMP”).
8. Ofcom has made two key changes to its definitions:
 - Firstly, it has taken account of LLU operators’ latest roll out plans and, as a consequence, approximately 1m households move into Market 3 from Market 2 (this accounts for two thirds of the change since Ofcom’s first consultation); and
 - Secondly, it has introduced a service share criterion so that BT exchange areas where only three POs are present will move from Market 2 to Market 3 if BT’s market share in that area is below 50%. This accounts for a further 0.5m homes (or one third of the total change)².
9. The first of these changes is relatively uncontroversial because, since the first consultation, LLU operators have placed additional firm orders to unbundle more exchanges and, as such, it is only right that Ofcom takes these latest plans into account when conducting its analysis.
10. However, Ofcom has erred in three ways in making the second of these changes because it has:
 - Relied too heavily on the uncommitted rollout plans of LLU Operators;
 - Not taken proper account of the lack of indirect constraints on BT at the boundary of Market 2 and Market 3; and
 - Interpreted historic market share trends incorrectly.

Uncommitted rollout plans of LLU operators are too speculative to be relied upon

11. It is imprudent to base any assessment of the prospect for competitive entry on the uncommitted rollout plans of LLU operators. Such plans could be subject to change and delay. As BT commonly discovers, aggregating operators’ longer term forecasts rarely proves to be an accurate indication of actual demand. Therefore, it is

¹ Under the new definitions, the proportion of the c25m UK business and residential premises that are served by Market 3 increases from 71.3% to 77.6%.

² Market 1: exchanges where only BT is present (11.7% of premises), Market 2: exchanges where 2 POs are present or forecast and exchanges where 3 POs are present or forecast but where BT’s share is greater than or equal to 50% (10% of premises); and Market 3: exchanges where 4 or more POs are present or forecast and exchanges where 3 POs are present but where BT’s share is less than 50% (77.6% of premises).

surprising that Ofcom cites these uncommitted plans when justifying the introduction of the 50% service share criterion into the market definitions;

“We expect this reduction in BT share to continue....Further reductions in BT’s market share may occur as a result of the possible additional LLU rollout indicated by POs beyond their currently confirmed plans.

Taking all this into account we propose that in exchanges where three POs are present or forecast to be present, an additional criterion of a BT service share threshold of 50 per cent, after migration is taken into account, should be included in the assessment of the boundary between Market 2 and Market 3.”³

And

“Therefore, in order to properly incorporate a forward look in our assessment we believe that a 50 per cent threshold is more appropriate. This is also more consistent with the greater than expected potential for future rollout that is reflected in the updated figures we present in this document. By using a higher threshold we implicitly allow for further reductions in BT’s actual share due to further rollout and the length of time necessary for LLU operators to grow market share once they have unbundled the exchanges.”⁴

12. Under the new EU telecoms framework, National Regulatory Authorities (“NRAs”) are required to conduct market reviews at three year intervals⁵. Therefore, the likelihood that these prospective rollout plans will have a material effect on the competitive conditions within these markets during the lifetime of this review is low. Indeed, it is apparent that, now the relevant market review period is shortened, NRAs will need to ensure that their forward looking assessments are based on more tangible factors than these speculative, uncommitted forecasts.

Lack of indirect constraints on BT at the boundary of Market 2 and Market 3

13. In responses to the first market review both BT and the EC suggested that the number of POs present within an exchange was not, in itself, a sufficient proxy for competitive conditions. It is in response to these comments that Ofcom has now proposed the 50% BT service share threshold criterion at the boundary of Market 3 and Market 2.
14. However, Ofcom has not demonstrated adequately that the 50% threshold is any better as a proxy for competitive conditions than, say, a 40% threshold, an alternative criterion or, indeed, the previous definitions that were based solely on

³ Paragraphs 3.100 – 3.101, “Review of the wholesale broadband access markets”, 20 August 2010

⁴ Ofcom, op cit, paragraph 3.94

⁵ Until now, Ofcom normally conducted market reviews at four year intervals (although we note that WBA markets were last reviewed in 2008).

the number of POs present. Further, Ofcom's new criterion fails to give sufficient weight to the lack of indirect constraints on BT at the boundary of these markets that allow it to act independently of its competitors and, ultimately, to maintain high pricing and poor levels of product functionality to the detriment of consumers.

15. The particular characteristics of the intermediate WBA market mean that BT is partially protected from the additional competitive constraints one would typically expect from increased market entry. In intermediate exchange areas where an LLU operator has not unbundled, it has two choices; either to continue to procure WBA services from BT Wholesale or to unbundle the exchange itself in order to self-supply. Market entry by another LLU operator or the presence of Cable does not benefit that LLU operator. This is because, generally, the non-BT POs present in the exchange area do not offer viable WBA services to any third party operators who only require WBA outside of their own LLU footprint.
16. Furthermore, BT has not responded to increased market entry in Market 2 by reducing its prices for WBA. Instead these remain stubbornly high. BT Wholesale only offers volume discounts over its Wholesale Broadband Connect (WBC) footprint which currently covers 55% of UK premises within Market 3⁶.
17. It is difficult for new entrants (for example, an LLU operator with a large unbundled footprint) to compete effectively with BT in the provision of WBA services to other LLU operators with smaller footprints who are seeking to offer off-net broadband services to their customers. BT is uniquely advantaged as it is the only operator able to offer WBA services ubiquitously (by definition, it is the only supplier of WBA services in Market 1). Yet for an LLU operator, there are very significant scale economies in using just one supplier of WBA services for all service provision outside of its own LLU footprint.
18. This is because such an operator procuring WBA services from a second off-net supplier it would end up incurring certain fixed cost more than once and added operational costs would be introduced into its business. For example, it would have to maintain:
 - More than one set of centralised circuits to receive the aggregated *bitstreams* from each of its WBA suppliers;
 - Two or more electronic ordering interfaces; and
 - A set of complex business rules within its internal Customer Relationship Management ("CRM") system and other associated information systems to manage more than one underlying wholesale service.

⁶ BT Wholesale has announced plans to increase WBC coverage to c70% by Spring 2011. Source: <http://www.thinkbroadband.com/news/4344-bt-announce-199-new-exchanges-for-wbc-adsl2-rollout.html>

19. In addition to the multiplication of certain infrastructures and their fixed costs, the operational overhead of maintaining separate suppliers is likely to be too burdensome to justify using more than one WBA supplier. This is especially the case given the low market penetration most LLU operators have in off-net areas. Given that only BT is able to offer WBA nationally (due to its monopoly in Market 1), ISPs who are also LLU operators, at least, are unlikely to use alternative WBA providers.
20. As a result, BT's market power is stronger than a mere inspection of market shares may suggest. BT is able to act to an appreciable extent independently of its competitors even where its market share is below 50%. This is borne out by the increasingly high returns on capital employed ("ROCE") that BT enjoys from its WBA services even though its market share in the old Market 3 is declining due to increased LLU-based competition. The inference is that the increasing profitability of WBA is being driven from outside of the old Market 3 areas (including those exchange areas that Ofcom is proposing to deregulate).
21. Given this evidence of a lack of competition in the wholesale market, we do not believe that Ofcom has justified properly that its new market definitions act as a useful proxy for competitive conditions in exchange areas. Specifically, Ofcom has not taken proper account of the ineffective indirect constraints on BT in some intermediate exchange areas.

Flawed interpretation of historic market share trends

22. We note that where a market share is in excess of 50%, dominance may be presumed, whereas it is unlikely to be found where shares are below 40%⁷. Therefore, for shares between 40% and 50%, where there is no presumption either way, a robust assessment of the indirect constraints present on the market is particularly important.
23. In its consultation, Ofcom presents two options for the additional market definition criterion which it says will act as a better proxy for the competitive conditions prevalent in an exchange area than one based purely on the number of POs present.
 - Option 1 – Exchanges where three POs are present (or forecast to present) are allocated to Market 3 if BT's share is less than 50%.
 - Option 2 – Exchanges where three POs are present (or forecast to present) are allocated to Market 3 if BT's share is less than 40%.

⁷ Paragraph 75 of the EC's "Commission guidelines on market analysis and the assessment of significant market power under the Community regulatory framework for electronic communications networks and services"

Ofcom appears to dismiss Option 2 on the basis that it expects BT's market share to continue to decline (especially in exchanges where 3 POs are present). As we have explained above, LLU operators' uncommitted rollout plans are not robust enough and should not form the basis for these important decisions.

24. In addition, the prospect of declining BT market shares is not by itself justification for adopting the 50% threshold as much will hinge on the rate of decline, forecast changes to that rate and the timing of prospective changes. It is not enough for Ofcom merely to highlight a general decline in BT's market shares, based on a number of unsubstantiated prospective competitive trends. Indeed, the European Commission has indicated that:

“the fact that an undertaking with a significant position on the market is gradually losing market share may well indicate that the market is becoming more competitive, but it does not preclude a finding of significant market power.”⁸

25. Ofcom states that, for those exchanges where BT's market share is above 50%, its share has been declining more modestly than for those exchanges where BT's market share is between 40% and 50%.⁹ Ofcom explains that this is justification for choosing Option 1 (50% threshold).

26. However, Ofcom has erred in its assessment of these trends in two ways:

- By definition, for exchanges to remain within Market 2 under Option 1, BT's share cannot fall below 50% (as opposed to 40% under Option 2) and, therefore, there is less scope for falls in BT's market share;
- The weighted average drop in BT's market shares since February 2008 is 22 percentage points for exchanges where BT's market share remains above 50% (Option 1) compared to 28 percentage points for exchanges where BT's market share remains above 40% (Option 2). Not only is the differential between the two options not large, it can, in part, be explained by the Option 2 definition which allows for greater falls in BT's market share than under Option 1.

A 40% market share threshold would be a better proxy for competitive conditions

27. Given the faults in Ofcom's assessment of the two options and the insufficient weight that has been given to the evidence of weak indirect constraints, it would be more appropriate, should Ofcom wish to continue with a market share criterion, for it to adopt a 40% market share threshold (as per Option 2). This would have the effect of moving around 120 BT exchanges back into Market 2.

⁸ EC, op cit, paragraph 75

⁹ Ofcom, op cit, paragraph 3.99

28. Alternatively, Ofcom could either seek some other criterion that is a better proxy for competitive conditions or revert back to its original definitions that are solely based on the number of POs present. But a viable alternative criterion has not been proposed and the EC has raised concerns with respect to Ofcom's original definitions.
29. Therefore, in order to address Ofcom's flawed analysis of historic market shares and over-reliance on speculative unbundling forecasts, Sky believes it is justifiable and expedient to adopt Option 2 (40% market share threshold) instead.

REMEDIES – MARKET 2 CHARGE CONTROL

30. Furthermore, many of the exchange areas that Ofcom originally proposed would be in Market 2 in its first consultation will now be moving into the competitive Market 3 (irrespective of which market share threshold is used). These exchanges are those that are most economically viable for further market entry through increased unbundling. Those exchanges that remain in the intermediate Market 2 will see less market entry as they are less viable to unbundle. Therefore, in contrast to our response to Ofcom's first consultation where the case was more marginal, we now consider that, imposing a "basis of charges" (cost orientation) remedy without an accompanying charge control in Market 2 will be insufficient to counter BT's ability to exert its market power and act on its incentives to earn monopoly rents in this market.
31. In particular, a charge control remedy will protect LLU operators who are not a PO in a Market 2 exchange area from BT's high WBA pricing. For the reasons already cited, the nature of the intermediate market is such that these LLU operators will neither benefit from lower BT WBA pricing nor from attractive alternative WBA supply from POs in these areas.
32. In order to protect consumers, the proposed WBA charge control remedy could be applied in both Market 1 and Market 2 (irrespective of the final decision on the new Market 2 definition). Such a move is unlikely to act as a brake on further investment by either BT through extended rollout of, say, ADLS2+, into Market 2 or by LLU operators wishing to unbundle Market 2 exchanges.
33. WBC is not even available throughout Market 3 yet. Moreover, BT's ROCE is significantly in excess of its cost of capital which indicates considerable scope for re-investment in newer technology. Whereas LLU operators assessing the case for further rollout place more weight on subscriber density in exchange areas and the availability of investment capital for unbundling rather than the price of BT's WBA.

34. Should Ofcom merely require Market 2 WBA to be cost oriented without setting specific price caps, then there is a strong possibility that BT will exploit this pricing flexibility and continue to enjoy high levels of profitability. As a result, a large proportion of consumers would continue to pay high prices for relatively constrained broadband services. An appropriately set charge control for WBA in Market 2 will go some way towards ensuring consumers pay lower prices and see much needed functional improvements in their broadband products.

Sky

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