CMA
Competition & Markets Authority

ANTICIPATED ACQUISITION BY BT GROUP PLC OF EE LIMITED

Summary of second hearing with Ofcom on 11 September 2015 concerning the VULA margin squeeze test

Background

1. Ofcom explained that the Virtual Unbundled Local Access (VULA) margin squeeze test had followed its 2014 fixed access market review. Ofcom had been concerned about whether there would be effective competition at the retail level given BT's significant market power (SMP) in relation to the supply of VULA (used by third party communications providers to supply superfast broadband). In that review, Ofcom had considered whether a cost-based charge control on the level of the VULA price would be more appropriate. The VULA service was still relatively new at the time and there had been concerns around the potential impact on incentives to invest and the risk of regulatory failure (ie setting the charge control at the wrong level). Ofcom had ultimately decided to introduce the VULA margin squeeze test, which obliged BT to maintain a minimum VULA margin and which Ofcom said was a form of price control.

2. Ofcom said that the objective of the test was to ensure that effective retail competition was not distorted by BT's market power in the supply of VULA, while at the same time giving BT flexibility to price at a level that allowed BT to recover its investment in that infrastructure. At the retail level, Ofcom noted that BT had control of a crucial input for its retail competitors. The concern was that control over that crucial input could be used to distort retail competition, and that any distortion of retail competition might be enduring. Ofcom considered this to be a significant risk. Although there were difficulties and complexities in setting the VULA margin control, the principle of introducing a control seemed right to Ofcom, given the risk of retail competition being distorted.

3. Ofcom said that BT had made very large investments in upgrading its network infrastructure to deliver superfast broadband services. The level of expected demand had been very uncertain at the time BT was making those investments. There was therefore concern that it might be quite difficult to set a cost-based wholesale charge control at the correct level, taking into account the risks BT ran when it made its investments. Ofcom had had to balance that

alongside the risk that BT would set an excessively high price for the wholesale VULA service.

4. Ofcom said that it had concluded that a cost-based wholesale charge control was not appropriate at the time of the last market review in 2014.

5. Ofcom told us that the VULA margin test required detailed cost data. It considered retail costs. In determining its approach, Ofcom had had to consider various additional issues. For example, when Ofcom was determining the appropriate way to calculate bandwidth costs, Ofcom therefore had to apply a number of adjustments because the number reported in BT's regulatory accounts was not quite right for the purposes of the VULA margin test.

6. Ofcom said that changes may be incremental, without having to redesign the entire test. For example, if BT added an additional line of business, as it had with BT Sport, it may not necessarily alter other aspects of the model.

7. Ofcom explained that it periodically conducted high level compliance assessments. As part of these, BT was required to provide data to Ofcom; Ofcom checked that data and determined whether it reconciled with BT's management accounts. On the basis of that assessment, Ofcom decided whether or not it had reasonable grounds to suspect that there was an infringement of the condition.

8. Ofcom said that once a process was regularised, it became easier to check and assess compliance. For the first compliance assessment for BT, Ofcom had specified the information it needed and had gone back to BT to be sure it received suitable information. However, Ofcom said that where BT provided appropriate and accurate data, and where no analytical changes were needed, actually 'turning the handle' on the model should be straightforward.

New subscribers

9. Ofcom told us that the test was based on new subscribers; existing VULA subscribers were not captured. This was because it had taken the view that the offers that BT made to new subscribers in the market were the ones that were most likely to affect BT's competitors and competition on the market. Also, as described below, applying the test to BT's entire subscriber base risked undermining its effectiveness.

10. Ofcom explained that it had designed the test to reflect the circumstances prevailing at the time. The test related to new subscribers, as Ofcom's principal concern was the risk that BT could set very low prices to new

subscribers while effectively 'subsidising' them from its existing base. Ofcom had designed the control to address that risk. Ofcom said that there was some possibility that BT might sell products with particularly low margins to its existing base as well, and, as stated in the VULA margin Final Statement (FS 6.68), it would have concerns about that, but Ofcom would treat that as a separate issue. While Ofcom recognised this concern, the main focus of the VULA margin condition was on the prices to new subscribers.

11. In the event that BT reduced prices for existing subscribers and not for new ones, Ofcom said that it would need to look at it, but the test, as designed, would not address this. Ofcom told us that this possibility would, however, be captured by the fair and reasonable charges condition, which was applicable where the VULA margin condition would not otherwise apply. This provided Ofcom with a regulatory mechanism for addressing concerns outside the VULA margin condition.

12. Ofcom said that the VULA margin condition distinguished between upfront costs and revenues (associated with customer acquisition) and ongoing costs and revenues.

13. Ofcom told us that one of the pieces of information that BT was required to report was the marketing expenditure required to acquire new customers. In terms of other types of marketing, where costs were not to do with acquisition, they were treated as ongoing costs. Ongoing costs were generally spread across the entire subscriber base. The implicit assumption Ofcom made was that the ongoing costs of serving a new subscriber were the same as the ongoing costs of serving an existing subscriber.

14. In relation to the extent to which the prices charged by the merged entity for its mobile offering would need to be captured by the VULA margin test, it was noted that there would be a number of BT superfast broadband subscribers that had EE mobiles pre-merger. Post-merger, those customers would receive both mobile and fixed from the same provider. Ofcom said that the key question would be whether the bundle changes. If those customers were paying the same amount both prior to and following the merger, with no discount, there would be a question mark over whether the mobile component would form part of a 'VULA-Based Broadband Package' (ie the bundles that the VULA margin condition applies to), as opposed to being a distinct product. If, however, customers received a discount on that mobile element then it would start to look much more like a bundled product that could be captured by Ofcom's definition of a 'VULA-Based Broadband Package'.

15. The definition of a 'new subscriber' was relevant to determining what packages (and therefore prices) were captured within the VULA margin

condition. Specifically, Ofcom said that a package was defined as ‘a bundle of products or service… offered by the dominant provider during the relevant compliance period through its retail divisions to new subscribers...’. On this basis, Ofcom explained that if a package was available to existing customers and new customers, the package would be captured within the VULA margin test in this context.

16. Ofcom further explained that if BT offered a package including both superfast broadband and mobiles services to new customers, but where existing broadband users could add on a mobile on the same terms, it would look at it under the VULA margin condition only in respect of new subscribers.

17. If it was the case that the mobile offer was rolled out across BT’s existing subscriber base and it started to look like that was leading to a situation where BT was selling products with very tight margins to its existing subscribers as well, Ofcom would consider what action needed to be taken in addition to the VULA margin condition. Ofcom explained that somebody who was a BT superfast broadband subscriber before the merger, who then took an additional mobile deal because BT was offering mobile as a result of the merger with EE, would be considered to be an existing subscriber. This would fall outside the VULA margin test but be captured by the fair and reasonable charges condition on BT. Ofcom would have the opportunity to consider whether charges were fair and reasonable under that condition.

18. It would be an option to amend the VULA margin condition to broaden its scope such that those packages were brought within that condition. Alternatively, the fair and reasonable charges condition could be used to assess pricing, although Ofcom said that the form of the fair and reasonable condition imposed was less specific than the VULA margin condition, and therefore offered a broader scope as to what was fair and reasonable.

19. Ofcom told us that it was possible to amend the VULA condition at any time, subject to certain procedural requirements. If Ofcom considered that it was sufficiently important and appropriate to amend the condition, it would not have to wait until the next market review; it was an option to amend the condition in advance of the next market review. It would have to consult on any change, including with the European Commission, as there was a notification requirement. Another possibility would be for it to bring forward the next market review.

The portfolio approach

20. Ofcom explained that it had adopted a portfolio approach in looking at the entirety of BT’s superfast broadband portfolio, including the average margins

across all different consumer types. Ofcom told us that one of the issues arising from adopting a portfolio approach was that, in principle, BT could still pass the portfolio test but set very low prices on one particular product provided that the low margin on one product is offset by a high margin on another. This concern had been raised by TalkTalk in its appeal. Ofcom had considered whether BT could, in the face of competition from its rivals, set a very low margin for one product, and achieve a high margin on another. Ofcom found that if BT pursued such a strategy it would risk being undercut by other operators on the high margin product.

21. Ofcom had considered whether to adopt an individual product test, and possibly a different (LRIC) cost standard, but there had been a number of reasons for not doing that. Such an approach would have required the allocation of common costs to individual products, which was a difficult task and was one where the regulator may make errors. There were a number of other drawbacks associated with it as well.

22. Ofcom told us that if BT had passed the portfolio test specified on a LRIC+ basis, it would be likely also to pass an individual product test specified on a LRIC basis.

23. Ofcom explained that when BT acquired a new subscriber it earned a margin on that subscriber for a period, which was assumed to be five years under the test. There was a cost to BT to acquire each subscriber, including marketing costs and, potentially, putting in equipment or other installation costs. The basic concept was that the flow of revenues over the five years should be sufficient to cover the upfront costs of signing up that subscriber.

Approach to BT Sport

24. Ofcom explained its approach to BT's Sport offerings. It told us that sport was a line of business that BT had added on to its traditional fixed telecoms business.

25. Ofcom's approach had been consistent with the objective of the VULA condition, which was to ensure effective competition through an adjusted Equally Efficient Operator (EEO) standard. It had adopted for BT Sport what it called a 'net costs approach'. This calculated the total costs of the BT Sport business and excluded revenues from sources such as paying subscribers on Sky's platform, pubs and clubs, and the wholesale deal with Virgin. The remaining revenue came from broadband subscribers, and it had allocated those revenues between standard and superfast subscribers based on the percentage of those customers which had taken the BT Sport channel which were also on standard and superfast packages.

26. Ofcom told us it had also considered how to allocate costs over time, and whether to 'tilt' the profile of cost recovery. One of the difficulties with adopting a tilting approach was that it required reliance on continuous forecasts over the duration of the control. There had been concerns that BT could game those or claim that there would be very large profits in the future. Taking into account future profits risks allowing BT to engage in a price squeeze (ie setting a low margin today supported by the expectation of high margins in the future). Ofcom also had to consider the data it would use. Ofcom developed the BT Sports aspect of its model based on BT's business plan. However, data had to be adjusted to make it fit for purpose in terms of properly spreading costs over time and not dropping things in a lumpy fashion. This ultimately led to the design of Ofcom's model.

27. Ofcom told us that BT had changed the way it offered its sports channels in August 2015, when BT began charging its broadband subscribers for access to certain channels. Ofcom had therefore issued supplementary guidance for the assessment of costs and revenues in those circumstances which would require a number of changes to the model to reflect the different way these costs were assessed.

Ability of test to incorporate new product bundles

Sport

28. Ofcom told us that the way it had set up the margin squeeze test was to provide detailed guidance about how it would assess compliance. Ofcom recognised that there were likely to be significant changes in the way BT was likely to sell its superfast broadband offers. For example, Ofcom had known that BT had spent a very large amount purchasing rights to UEFA Champions League Football, but it did not know how exactly BT had planned to integrate it with its existing offers. It also knew that the merger was on the horizon, and that BT was considering bringing in a quadruple play mobile offer. But again, it did not know how that was going to be done. Ofcom thus explicitly recognised that its guidance may need to change in the event of a material change in circumstances. Ofcom said it could also change the way it assessed compliance with the condition if changed circumstances warranted it.

29. Ofcom told us that when it became aware of how BT was going to incorporate its UEFA sport offering into its offers, Ofcom had issued additional guidance and adjusted its approach for those bundles accordingly.

30. If the merger went ahead, Ofcom would consider how the parties integrated their offers or how they cross-sold them. Ofcom told us that it had been clear

that if there were material changes in circumstances, it would reassess how it dealt with costs, revenues and other related questions. In that case, some new costs might be straightforward to incorporate into what it had in place already. Other costs might raise new issues that it could deal with by providing additional guidance.

Mobile

31. Ofcom stated that mobile services, like BT Sport, were an example of BT adding a component to its superfast broadband bundles. If mobiles created a challenge for Ofcom, it would think about how best to deal with that challenge.

32. Ofcom told us that it anticipated an ongoing monitoring process whereby it would request data from BT, examine it, and consider whether it was being assessed in the right way with costs being allocated appropriately. If Ofcom was not satisfied or if it had further questions, it would go back to BT using the information gathering powers it had under the condition.

33. Ofcom told us that BT's next compliance assessment would cover the period from April 2015 to September 2015. BT would be submitting the data for this period at the end of October.

34. On the assumption that the data BT was required to report included mobile costs and revenues, Ofcom would look at it as part of the compliance process. Its first question would be whether the revenues from mobile were actually material enough to affect the test. If they were, then Ofcom would consider how to take account of those costs.

35. Ofcom said that it would always be guided by the objective of the condition, which was to ensure effective retail competition in superfast broadband. In the event that the mobile business started to look very different and this called into question whether further adjustments were needed to its benchmark, it would consider whether to issue supplementary guidance, or amend the condition. Whether that became necessary would depend on how things played out; for example, if it looked as if BT was starting to gain a unique advantage as a result of its mobile business that no other competitor could match, Ofcom would need to consider how best to address that.

36. Ofcom told us that it had previously been able to respond quickly to changing circumstances. Its original guidance, as designed, had reflected the state of the market as of March 2015, when it was put in place. Ofcom had adapted this guidance as the result of the changes to BT Sport in August 2015 and, if there were further changes in the future, it would also adapt its approach accordingly.

37. Ofcom said that there was not a pre-notification regime where BT was required to check with Ofcom before it put an offer into the marketplace. Ofcom had considered this, and some stakeholders had argued for it, but the risk was that it would restrict BT's commercial freedom. Ofcom had found in practice that BT engaged with it in advance. In the case of adding UEFA rights, BT had approached Ofcom for further guidance. On mobile, if BT wanted to do something quite different from what it had been doing, Ofcom thought that BT may take a similar approach. Ofcom said it would be surprised if BT did not give it some idea in advance of what BT was proposing, not least because BT would want to understand ahead of time what and how the rules might apply.

Ongoing monitoring

38. Ofcom stated that the time taken to adapt the calculation undertaken for the VULA margin test depended on the circumstances. In the case of UEFA, BT had written to Ofcom on 2 April 2015 asking for Ofcom's views on how it would approach the issue. Ofcom wrote back to BT on 21 April 2015 giving an indication of its position and stating that it would consider the issue further. Ofcom proceeded to gather additional data from BT and issued a consultation document on 9 June 2015. The public consultation period lasted four weeks and Ofcom produced a statement setting out supplementary guidance on 13 August 2015. Ofcom said that how long another variation would take would depend in part on how long it would take Ofcom to identify which costs required amendment. Depending upon the complexity of the issue, it might not be necessary for Ofcom to go through a consultation and issue amended guidance. In terms of assessing BT's compliance within the confines of the SMP condition as it stood, it wasn't necessary for Ofcom to seek BT's view before deciding to assess costs or revenues in a particular way. BT could set its prices on risk.

39. Ofcom stated that with regard to timing of the test, it took a pragmatic approach as its objectives were to make sure that the regulation worked when complications arise. Ofcom said that BT also had an interest in making sure it complied. Ofcom explained that the six-month reporting mechanism was to enable Ofcom to receive information on a sensible, periodic basis and that there was nothing preventing Ofcom from requesting data or opening an investigation within this period. BT's competitors would also be able to approach Ofcom under the Communications Act if they believed BT was in breach of one of its conditions. Ofcom said that in the event that Ofcom opened a dispute under that Act, it must determinate that dispute within a four-month timescale (except where there were exceptional circumstances).

40. With regard to its next wholesale local access market review, Ofcom said it would not be looking solely at the VULA issue, but it would consider whether the current approach to the test remained the most appropriate approach. Ofcom explained it will look at the wider regulation including input charge controls on LLU and look again at whether a cost-based wholesale charge control is appropriate for VULA. Ofcom said it was aiming to complete this review by March 2017, as a number of existing charge controls expired at that point.

Incorporation of mobile into the test

41. Ofcom said that the test would consider the average revenue from a superfast broadband subscriber who took mobile. Ofcom said it believed that the nature of the question was the same in both the counterfactual and post-merger. As a result, Ofcom explained that it did not consider it to be particularly complicated within the confines of the current test. Ofcom explained that the level of complexity in assessing BT's costs post-merger would depend upon how it structured the two businesses and the extent of integration. Ofcom said that when assessing BT's margins for VULA it looked at the price BT was charging for VULA, rather than the underlying cost of providing it. But for other items, such as sport or TV, Ofcom assessed the costs.

42. Ofcom was not sure how the merged entity would be structured and had not considered how the mobile business would be integrated. It was therefore difficult to answer precisely what Ofcom would do with MBNL costs. It would be easier for Ofcom to calculate the test if the mobile business was run separately from the rest of the BT Group. If costs were being shifted between BT's fixed and mobile business, it would become more complicated. Ofcom emphasised that it would take a pragmatic approach to regulation going forward and its objective was to make sure this regulation continued to work. Ofcom stated that it could deal with the merger, as the regulation allowed it to address new circumstances in an effective way. Its ultimate goal was to ensure that BT did not use VULA to distort retail competition. If Ofcom became concerned that its regulation was becoming ineffective as a result of the merger, it would find a way to make it work by utilising the range of powers available to it.

43. With regard to how, in the counterfactual, BT's plans to offload mobile data traffic to its Wi-Fi network might have affected Ofcom's cost allocation, Ofcom said that if BT was to make use of its own network assets, either spectrum or its Wi-Fi network or other things, because those were part of the cost of serving its mobile business in the counterfactual, Ofcom would consider how to take those into account. Ofcom considered that the level of added

complexity arising from the addition of mobile might be similar in the counterfactual situation and post-merger.

44. Ofcom explained that in terms of the counterfactual, there were likely to be complexities both in terms of the network assets BT would have used and other factors such as allocating the retail cost between customers who use superfast broadband. Ofcom said there was currently no allocation to mobile from the existing account, because BT had had no mobile business until recently. In the future, if BT had been running a mobile business, Ofcom would expect that some of the network costs might be allocated to that business and it would have to think about them.

45. Ofcom stated that if customers who take mobile and superfast are different from the ones who take mobile but not superfast, then it might have to start thinking about apportioning costs in a more sophisticated way.

46. Ofcom said that it had not had to consider whether a customer who subscribed to BT superfast broadband and also took mobile services from BT with no discount, no linkages and two separate contracts were included for the purposes of the VULA test. In the no discount case, Ofcom said it was questionable whether or not such customers' mobile services fell within scope of a 'VULA-Based Broadband Package' (see paragraph 15 above). Ofcom alluded to a similar point in the context of the sport offering from BT. Ofcom explained that if there were no discounts for BT broadband customers who took sport and it was not bundled in the way it was today, it was not clear that it would think about the sports business in the way it currently does.

47. Ofcom said in relation to the limited number of BT customers who took fibre to the premises, Ofcom did not undertake any separate modelling or a separate assessment because it was very unlikely to change whether BT passed or failed the test. In terms of a mobile business, Ofcom said that it was difficult to say at what point something became material. If it was the case that very few people subscribed to BT Mobile, or initially very few people subscribed, Ofcom believed putting the costs and revenues to one side on the basis they were not going to influence the outcome either way would be a pragmatic approach.

48. With regard to the operation of the VULA margin test in practice, to date Ofcom had completed one trial calculation based on the April 2015 data and it had not yet done the first full six-month run. Ofcom said that it believed once the test is regularised and in place, it would be simple to apply in the absence of changes or new complications. Ofcom stated that difficulties arose when the industry changed, and at such point it had to consider whether the way the

data was being presented and way the test was being conducted was still correct.