# BT-EE merger: further Ofcom submission to the CMA

## Introduction

1.1 The CMA has requested that Ofcom provide further detail on the VULA margin regulation imposed on BT. This regulation is set out in our statement of 19 March 2015 (the 'VMS').[1] Ofcom provides this note ahead of the meeting with the CMA on 11 September 2015.

1.2 This note outlines the following:

- First, Ofcom sets out an overview of our regulation of the VULA margin. This overview describes the relevant SMP condition, including the information requirements on BT, and Ofcom's approach to assessing compliance with that condition.
- Second, Ofcom discusses other examples of costs that have been incorporated into the VULA margin assessment.
- Third, Ofcom discusses the likely impact of the proposed merger on the VULA margin regulation. We set out our understanding of the theory of harm that the CMA is considering, describe how our approach provides flexibility to respond to changing circumstances, discuss whether complexity increases relative to the counterfactual and provide some observations on how costs might be assessed.

1.3 In summary, Ofcom recognises the complexities involved in assessing compliance with its VULA margin regulation. Indeed these are a consequence of designing that regulation to be flexible in the face of changing circumstances. However, in developing its approach to VULA margin regulation, Ofcom has already had to consider challenging analytical issues. Therefore, Ofcom considers that its approach is sufficiently flexible to address any added complexity arising out of the merger.

## Overview of VULA margin regulation

### The SMP condition

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1.4 SMP services condition 14 (the 'Condition') requires BT to set the charge for VULA so that a minimum margin is maintained over any "*Compliance Period*".[2] A copy of the Condition is attached to this note. This is supplemented by guidance on how Ofcom would assess BT's costs and revenues to determine whether it was complying with the Condition.

1.5 The Condition was imposed as part of Ofcom's previous review of the wholesale local access market, which covered the period until 31 March 2017. The extent to which the Condition continues in force beyond this period will depend on the outcome

[1] http://stakeholders.ofcom.org.uk/consultations/VULA-margin/statement/
[2] A Compliance Period comprises a calendar month.

of Ofcom's next review of the wholesale local access market which will revisit the regulation of BT's local access network, including services such as VULA.

1.6 BT and TalkTalk each appealed the Condition on 19 May 2015 and these appeals raise both non-specified and specified price control matters.[3] Since no application has been made for interim relief, the Condition remains in force throughout the appeals until any order is made directing otherwise. The appeals are in their early stages with Ofcom due to submit its defence in each appeal on 5 October 2015, with statements of intervention and replies to follow. A hearing to consider the non-specified price control matters is listed for 9 to 17 December 2015 while a reference in respect of the specified price control matters to the CMA will not be made until after 17 November 2015. Insofar as any of these appeals results in changes to the Condition, any order directing such changes is unlikely to be made before Spring 2016 at the earliest, with any subsequent exercise by any party of further appeal rights possibly pushing this date further out.

## Condition requirements

1.7 Condition 14.2 sets out the requirement on BT to maintain a minimum margin by reference to the total costs and revenues "*associated with the supply of VULA-Based Broadband Packages to New Subscribers*". "*VULA-Based Broadband Packages*" are defined in Condition 14.4 as:

> "…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 [i.e. BT] during the relevant Compliance Period 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".

1.8 Accordingly the costs and revenues of VULA based superfast broadband ('SFBB') retail bundles which include mobile services form part of the assessment of whether BT is maintaining a minimum margin.

1.9 Condition 14.3 requires BT to record, maintain and supply to Ofcom the data necessary for Ofcom to monitor compliance. This includes a requirement for BT to provide such other data as Ofcom may direct from time to time (Condition 14.3(f)). BT is required to provide this data every six months in relation to the periods 1 April to 30 September and 1 October to 31 March. This allows Ofcom to check BT's compliance in each calendar month biannually (although Condition 14.3 does allow Ofcom to direct BT to provide data for other time periods).

1.10 In addition to the normal biannual compliance assessment, BT was also required to provide data relating to April 2015 i.e. the first month during which the Condition was in force.

[3] http://www.catribunal.org.uk/237-8833/1238-3-3-15-British-Telecommunications-PLC.html and http://www.catribunal.org.uk/237-8831/1237-3-3-15-TalkTalk-Telecom-Group-PLC.html.

### Ofcom's compliance assessment process

1.11 Ofcom carried out a high level assessment of the data relating to the April 2015 Compliance Period provided by BT. We concluded that we did not have reasonable grounds to suspect that BT is contravening, or has contravened the Condition.[4]

1.12 Prior to the publication of the VMS, we met with BT to understand what information was available. To give BT a clear indication of the information that we require in order to assess compliance, we provided BT with indicative templates for it to fill in. This data was the input into an Ofcom model that calculates the VULA margin.

1.13 In carrying out our high level assessment of whether BT complied in April 2015:

- We checked whether the data provided by BT reconciled to its audited management accounts, including whether there were items in the management accounts that had been omitted from the data provided by BT;
- Where the data originally provided by BT was not sufficiently detailed or disaggregated, we obtained further suitable information from BT; and
- Ofcom considered whether or not changes to our model were needed to reflect the Condition and the principles set out in our guidance.

1.14 It is important to recognise that it is Ofcom that carries out the compliance assessment. While we will carefully consider data provided by BT and any arguments it makes about how we should calculate the VULA margin, ultimately Ofcom decides the appropriate way to conduct that assessment (in line with the Condition) and we can request further data if we require it.

## Examples of other complex issues that Ofcom has addressed

1.15 In developing our approach to assessing compliance with the Condition, Ofcom has had to consider a number of complex issues and incorporate them into the VULA margin assessment.

1.16 Mobile services are not the only feature that could be added to BT's SFBB bundles. In 2013, BT added sports content to its broadband bundles. As a result, in the VMS we had to consider a range of issues in relation to the treatment of BT Sport. These included: (i) the appropriate concept for addressing this component; (ii) how to allocate certain lumpy BT Sport costs over time; (iii) how to allocate BT Sport costs between SFBB subscribers and other customer groups. In carrying out our high level assessment of BT's compliance in April 2015, we also had to consider what data we required from BT in relation to this new BT Consumer business to enable us to assess BT's compliance with the Condition. Moreover, in the light of material changes to the BT Sport proposition in August 2015, we have issued supplementary guidance that adapts our approach.[5] As a result, when we assess BT's compliance during the period April 2015-September 2015, we anticipate that we will need to adapt both data we request from BT and the model that we use to assess compliance.

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[4] http://stakeholders.ofcom.org.uk/enforcement/competition-bulletins/cases-in-compliance/bt-compliance-vula-margin-control/

[5] http://stakeholders.ofcom.org.uk/binaries/consultations/vula-margin-guidance-supplementary/statement/VULA_margin-supplementary_guidance.pdf

1.17 In specifying the guidance set out in the VMS, we had to consider how to calculate bandwidth costs. In determining our guidance on unit bandwidth costs we considered whether the bandwidth cost figure in the BT regulatory accounts was suitable and identified a number of adjustments that are necessary for the purposes of assessing the VULA Margin. Based on information we gathered from BT, we included guidance on adjustments to accurately account for the costs associated with the backhaul, interconnection and core transmission activities used to supply SFBB services.[6] Moreover, it is possible that further adjustments may be appropriate in the future.[7]

## Impact of the proposed BT-EE merger

### Theory of harm

1.18 Theory of harm 6 in the CMA's statement of issues relates to the wholesale inputs, including VULA, that rival communication providers need to provide retail broadband services. The CMA indicated that it is interested in assessing "whether the merger will increase complexity in such a way as to make the VULA margin squeeze regulation ineffective…"[8]

### Flexibility to respond to changes in circumstances

1.19 Even absent the merger BT could add new components to its SFBB bundles, as it did in 2013 when it launched BT Sport. Ofcom designed its VULA margin regime to be flexible. Indeed it is this inbuilt flexibility that means that assessing compliance is more complicated than, say, assessing compliance with a 'traditional' charge control.

1.20 In response to material changes Ofcom could:

- Where appropriate, depart from the guidance when taking those changes into account as part of a compliance assessment;
- Amend its guidance (as was done to reflect the changes to BT Sport in August 2015);[9] or
- In the event that any changes meant that the Condition is no longer appropriate in its current form, Ofcom could amend it. Ofcom does not anticipate that the merger will require it to amend the Condition since the guidance gives the Condition sufficient flexibility to address any added complexity arising out of the merger.

1.21 Different types of change involve different processes:

- When assessing compliance with the Condition, Ofcom will adopt the approach it considers the most appropriate given circumstances at the time. In the event that this involves departing from our previous guidance, where appropriate we would

[6] As set out in paragraphs 6.120-6.126, 6.136-6.149 of the VMS and guidance box following paragraph 6.172.
[7] We also specified a floor on unit bandwidth costs in the SMP condition. VMS, paragraphs 6.163-6.170. See also the definition of "*Relevant Bandwidth Costs*" in Condition 14.4.
[8] https://assets.digital.cabinet-office.gov.uk/media/55a8c150e5274a6fea00000d/BT-EE_-_issues_statement.pdf
[9] http://stakeholders.ofcom.org.uk/binaries/consultations/vula-margin-guidance-supplementary/statement/VULA_margin-supplementary_guidance.pdf

provide appropriate transparency on this. Decisions in relation to enforcement can be appealed to the CAT.

- Before amending our guidance, we would likely publicly consult on our proposed changes for a period of at least one month.

1.22 In addition Ofcom has begun its next review of the wholesale local access market, covering the period after March 2017. As part of that new review we will be revisiting the way in which we regulate BT's local access network, including services such as VULA.

## Comparison with the counterfactual

### Introduction

1.23 Whether the proposed merger increases complexity, and if so by how much, depends on the counterfactual. Our understanding is that, in the counterfactual adopted by the CMA for the purposes of its assessment, BT would supply retail mobile services. As discussed in Ofcom's Phase II submission of 31 July 2015, BT may act as an 'MVNO plus' in the counterfactual i.e. as well as entering into an MVNO agreement with an MNO, BT would also use its 2.6GHz spectrum and its own network assets to support its mobile services in some areas.

1.24 In order to assess compliance with the Condition, Ofcom needs to estimate the average retail revenue associated with SFBB subscribers and deduct both the average retail costs of supplying those subscribers and the average wholesale charges for VULA and WLR. Irrespective of whether or not the merger proceeds, Ofcom is likely to need to consider the costs and revenues associated with the supply of mobile services to SFBB subscribers.[10]

### Impact of the proposed merger on the complexity of assessing revenues

1.25 It is not obvious that assessing the average retail revenues associated with BT SFBB bundles that include mobile services would be significantly more complex post-merger than in the counterfactual. In both scenarios the revenue sources and data used may be the same.[11]

### Impact of the proposed merger on the complexity of assessing costs

1.26 Below Ofcom discusses the complexity of assessing the average cost associated with providing mobile services to SFBB subscribers, highlighting a number of issues that may arise under both the counterfactual and post-merger. However, it is difficult for Ofcom to comment on the impact (if any) of the merger on the complexity of the VULA margin assessment since it depends on:

- precisely how BT operates its mobile business in the counterfactual; and

[10] In line with the Condition, if BT bundles SFBB and mobile services together then Ofcom would likely need to take mobile costs and revenues into account. We discuss how this might be done below. That said, Ofcom adopts an adjusted EEO standard when assessing the VULA margin. In the event that BT's mobile arm granted it an unmatchable advantage over other operators then we would likely need to take this into account. In these circumstances it may not be appropriate to use BT's costs and revenues.

[11] Revenue categories that we would likely include are set out at paragraph 6.72 of the VMS.

- what data is available from BT. Ofcom does not know how BT would structure and record its costs and revenues in either the counterfactual or the post-merger scenario.

1.27 In the counterfactual, the payment that BT (as an MVNO) makes to its MNO partner is unlikely to capture all of the costs incurred by BT in providing mobile services. Rather, in both the counterfactual and the post-merger scenario, some of the costs of providing mobile services relate to assets owned by BT and activities that BT itself carries out. To illustrate, it is helpful to consider the following broad cost types incurred by a mobile business:

- Network costs relating to the radio access network, backhaul and the core network;
- Spectrum costs;
- Outbound termination and other interconnection costs;
- Retail costs such as marketing, customer acquisition and retention, customer services (call centres etc), handset subsidies, sales agent fees etc; and
- Overheads such as management, IT systems, product development etc.

1.28 Taking each of these categories in turn:

- In terms of network costs, in the counterfactual BT may act in some respects as an MVNO, making use of its wholesale MNO partner's network infrastructure in return for paying wholesale charges. However, this does not mean that the wholesale MVNO charges reflect all of the network costs incurred by BT. BT might also make use of its fixed infrastructure, for example by affixing small cells to its street furniture or by offloading traffic onto its existing Wi-Fi network.
- In terms of spectrum costs, in the counterfactual the wholesale charge that BT pays to its MNO partner would presumably include an amount for the use of that MNO's spectrum. However, in addition, BT would presumably make use of the 2600MHz spectrum that it holds.
- Whether, in the counterfactual, outbound termination costs are included in the wholesale charges BT pays its MVNO partner depends on the specific terms of its MVNO arrangement.
- In terms of retail costs, in the counterfactual it seems plausible that the bulk of these costs would be incurred by BT, rather than being recouped via the wholesale charge it pays its MNO partner.
- In terms of overheads, in the counterfactual at least some of these costs would be incurred by BT, rather than being recouped via the wholesale charge it pays its MNO partner.

1.29 In both the counterfactual and the post-merger scenario, Ofcom may need to consider 'lumpy' one off costs:

- In the counterfactual there may be costs associated with setting up a new mobile business.

- Post-merger, there may be various one-off costs associated with integrating the EE business within the BT Group.

1.30 We have identified a possible additional complication that could arise in the counterfactual but not in the post-merger scenario. In the counterfactual, if BT is growing its mobile business from scratch then initially it would have only a small number of mobile subscribers. As a result, at least in relation to some cost categories, BT may initially lack economies of scale. In these circumstances it may be necessary to consider whether to make some adjustments to the way in which compliance is assessed in order to reflect the initial period during which take up of BT mobile services is atypically low.[12]

## Potential approaches to assessing the cost of providing mobile costs

1.31 Ofcom has not yet had to consider mobile costs and revenues as part of a compliance assessment. In paragraph 6.71 of the VMS we stated that:

> "It is not possible for us to provide detailed guidance on the treatment of mobile services before they have been launched – even if it was certain that BT will begin to offer mobile services, the assessment approach would likely depend on how BT configures its mobile network and how it sets charges to end users."

1.32 Nonetheless below we set out some preliminary observations on how the average cost associated with providing mobile services to SFBB subscribers could be assessed. Clearly, this is based on the limited information available and any appropriate approach will need to be determined in the context of how BT actually chooses to bundle mobile services with SFBB.

1.33 It may be the case that modifications to how we assess BT's compliance are incremental in nature. By this we mean that the approach to assessing the costs of the existing components of BT's SFBB bundles (TV, sport etc) remains unchanged. Rather the changes relate to how to assess of the additional mobile element. Whether this is possible depends on the extent to which the costs of BT's mobile operation are recorded separately from the costs of BT's existing operations. Therefore, in considering how we would assess these costs, we will need to consider the information that BT holds on its mobile services.[13]

1.34 The level of detail in which the costs of BT's mobile business need to be assessed depends on the facts. To illustrate:

- Suppose that relatively aggregated data indicates that the ongoing costs of serving mobile customers (opex and amortised capex) were £100m per month (an illustrative figure). If there were 20m mobile subscribers in total then the average cost per mobile subscriber is £5/month. If there was evidence that BT consumers that take mobile services and SFBB were similar to BT mobile customers as a whole then it may be appropriate to use that £5/month ongoing

[12] In August 2015, BT made various changes to its BT Sport proposition. In particular, it started charging broadband subscribers for access to certain channels. To reflect the possibility that, initially, take-up of these channels is atypically low Ofcom issued supplemental guidance on the treatment of certain BT Sport costs. http://stakeholders.ofcom.org.uk/binaries/consultations/vula-margin-guidance-supplementary/statement/VULA_margin-supplementary_guidance.pdf

[13] As discussed in paragraph 1.12 above, prior the publication of the VMS, we met with BT to understand what information was available.

cost when assessing the VULA margin. In other words, a detailed assessment of ongoing mobile costs may not be necessary.

- On the other hand, if there was evidence that BT customers that take mobile services and SFBB were not the same as BT mobile customers as a whole then it may be necessary to consider certain cost categories in more detail. For example, if customers that take mobile services and SFBB on average generate more mobile traffic then it may be necessary to identify those cost categories that are likely to be driven by traffic levels. These cost categories could then be allocated in proportion to the amount of traffic generated by mobile subscribers that do and do not take SFBB.

- Ofcom would need to consider whether the figure for the ongoing costs of the mobile business (£100m per month in the above example) is reliable. Moving costs into or out of this category may be able to affect the outcome of the VULA margin assessment. The reliability of this figure depends on how BT structures its business and its accounts (e.g. to what extent is BT's mobile arm separate from the wider BT business – in the case where this is run as an 'arm's length' subsidiary reliably identifying these costs may be straightforward).

1.35 Finally if few BT SFBB subscribers take mobile services, mobile costs and revenues could be disregarded as a simplification. This is analogous to our treatment of FTTP bundles when assessing the VULA margin.[14]

1.36 As discussed in paragraph 1.9 above, the Condition allows us to obtain information from BT to assess its compliance.

Ofcom

9 September 2015

[14] See paragraph 6.58 of the VMS.