

BT Response to Ofcom VULA Margin Consultation

ANNEX D

MARGIN SQUEEZE TEST IMPLEMENTATION BY OTHER NRAS IN THE EU

Introduction and summary

- 1.1. In this Annex, we review the implementation (or proposed implementation) of ex-ante margin squeeze tests (“MST”) by NRAs in eight European countries (see Table 2 below). The scope, design, and implementation of MSTs in each country are different as each MST reflects the market structure and level of competition in the relevant country. However we note that, unlike the approach specified in the Consultation:
- (a) A common feature is flexibility built into the MST to reflect varying levels of competition in different product and geographic markets.
 - (b) Some NRAs also make allowances for mitigating circumstances which may help explain why an incumbent operator fails the MST in a particular instance.
 - (c) The majority of NRAs consider the entire subscriber base when assessing the revenues and costs in the MST.
 - (d) Other NRAs tend to apply a forward-looking approach with retrospective checks and apply the portfolio test at most once every year.
- 1.2. We explain these points further below.

Flexibility built into the MST

- 1.3. Reflecting differences in market structure and levels of competition (Table 1) many NRAs have adopted combinatorial ex-ante MSTs covering a wider range of services compared to Ofcom (for example SBB and voice in addition to SFBB), with varying definitions of portfolios and applying different cost standards and cost benchmarks at the product by product and portfolio level.
- 1.4. However irrespective of the particular scope, design, and implementation of the ex-ante MST in these European countries, a common feature is flexibility built into the MST to reflect varying levels of competition in different markets. For example the choice of the cost benchmark and/or cost standard used in the MST may reflect the presence of competitive pressure imposed by cable operators (nationally or in some exchange areas) and/or higher levels of competition in the provision of unregulated services such as TV. For example:
- (a) In the Netherlands where DSL entrants and cable operators have a relatively high market share, the NRA applies the same standards used in competition law, namely an EEO cost benchmark and a long run incremental cost (LRIC) cost standard. However the MST is implemented at a product by product level, not at a portfolio level.
 - (b) In Ireland, where entrants have gained market share over the past few years and the cable operator (UPC) has a strong position (in areas where the cable

network exists), the NRA provides the incumbent with more pricing flexibility in competitive areas.

- (c) In Austria, where cable operators enjoy a strong market position, the NRA applies an EEO cost benchmark and an ATC cost standard which is applied to a wide portfolio which includes all broadband products. The cost standard used in the product by product test is average avoidable cost (AAC).
- (d) TV services if included in the MST are generally included at their LRIC. For example:
 - (i) in Ireland, Spain and the Netherlands, NRAs include the LRIC of TV services in the MST;
 - (ii) in Italy and Denmark, these costs are excluded from the product-by-product test and only included in the portfolio test at their LRIC; and
 - (iii) in Austria, the NRA considers these services to be provided under competitive conditions and hence their revenues and costs are excluded from the MST.

1.5. The aim of building in flexibility into the design of the MST is to strike the right balance between promoting competition in the market, and providing incumbent with sufficient flexibility and incentives to compete and invest. Providing incumbents sufficient flexibility is particularly important in market segments where they face higher levels of competition (for example the provision of triple play bundles as opposed to double play bundles) and/or in the provision of services (such as TV) where the incumbent operator may be an entrant and may not be in a strong competitive position.

1.6. In contrast to the approach taken by various other European NRAs, Ofcom's proposed test fails to explicitly consider and reflect differences in competitive conditions faced by BT in:

- (a) Different geographic areas, for example BT faces more competition in exchanges with unbundled operators and/or exchanges covered by Virgin's cable network; and
- (b) Different markets i.e. the Pay TV and the broadband markets. BT is an entrant in Pay TV markets which is dominated by Sky.

Mitigating circumstances

1.7. In addition to designing flexible MSTs as described above, some NRAs also make allowances for mitigating circumstances which may help explain why an incumbent operator fails the MST in a particular instance. The allowance for mitigating circumstances recognises that an ex-ante MST does not capture the complexities of an effects based test and that the incumbent operator failing the MST does not automatically mean that competition is distorted. And if competition has not been distorted then the case for regulatory intervention is unclear. For example:

- (a) ComReg conducts a case by case assessment of the reasonableness of a bundle if it does not pass the relevant test. Mitigating circumstances include retail

efficiencies and related savings, increased customer lifetimes, and a competitive assessment (which includes relevant commercial and strategic reasons for the offer, the duration and scope of the offer, and whether the pricing is likely to have an appreciable effect on existing OAOs or potential new entrants, and the medium to long term implications for retail pricing and consumers etc).

- (b) The Danish NRA allows the incumbent to fail the MST if the squeeze is a result of the incumbent meeting competition (regardless of the price level) i.e. if another CP is the price leader the incumbent is allowed to price below the level required to pass the MST. If the other CP subsequently increases its prices and the incumbent is the only operator pricing at a level resulting in a margin squeeze, the incumbent has two months to amend its prices and pass the MST.
- (c) The Croatian NRA also proposes to allow for mitigating circumstances if the incumbent fails the MST, such as when the incumbent is meeting the competition or when future efficiency improvements (like cost reductions) are expected.

1.8. Again Ofcom's test makes no allowance for mitigating circumstances i.e. valid reasons why in some cases failing the MST is unlikely to 'distort competition'.

Subscriber base

- 1.9. The majority of NRAs consider the entire subscriber base when assessing the revenues and costs in the MST.
- 1.10. Among the eight jurisdictions analysed, only the Italian NRA uses new subscriber acquisitions in the MST but it does so over a one year time horizon. The other seven NRAs consider both new and existing subscribers when measuring the costs and revenues in the MST.
- 1.11. Unlike most other NRAs Ofcom's proposed test is based on new subscribers instead of the entire subscriber base, consisting of existing and new subscribers.
- 1.12. The focus on subscribers acquired in the last 6 months narrows the scope of the test considerably. For example, in some testing periods the result may be a product by product test (instead of a portfolio test) if one product bundle proves popular during the preceding 6 months.
- 1.13. Ofcom argues that using the total subscriber base would allow BT to use margins on existing subscribers to subsidize new subscribers, and because rivals have a relatively smaller SFBB subscriber bases they would not be able to replicate such a strategy. However the focus on SFBB overlooks the fact that BT's rivals have large SBB customer bases, and margins from these SBB subscribers could be used to compete for SFBB customers (while BT would not be allowed to do so).

Forward looking approach

- 1.14. Other NRAs tend to apply a forward-looking approach with retrospective checks and apply the portfolio test at most once every year. In particular:

- (a) Six NRAs use a discounted cash flow (DCF) approach or take account of known or expected future changes in the MST.
 - (b) Four NRAs apply the portfolio test at most once every year.
- 1.15. Ofcom's proposed test is backward looking and there seems to be no allowance to take into account known changes and/or BT's commercial strategy. Known changes may include retail / wholesale price changes, additional revenue streams etc.

Table 1 – Key broadband market indicators

	IT	IE	ES	EL	HR	AT	NL	DK	UK
Broadband and NGA household penetration									
Broadband penetration	23%	26%	26%	26%	22%	27%	41%	41%	34%
NGA penetration	3%	35%	25%	2%	1%	16%	59%	42%	31%
OAO retail market share									
OAO market share	50%	62%	53%	57%	43%	42%	58%	41%	67%
Of which Cable	0%	28%	17%	0%	11%	31%	46%	28%	20%
OAOs using LLU	70%	5%	85%	98%	71%	77%	69%	49%	77%
OAOs using Bitstream	29%	74%	11%	1%	29%	21%	23%	28%	17%

Source: EC (2014), 'Trends in European Broadband Markets 2014, 28 May.

Note: IT (Italy); IE (Ireland); ES (Spain); EL (Greece); HR (Croatia); AT (Austria); NL (Netherlands); DK (Denmark); UK (United Kingdom).

Table 2 – Implementation of ex-ante MST in different European countries

	Italy (2010)	Ireland (2013)	Spain (2013)	Greece (2011)	Croatia (2014)	Austria (2013)	Netherlands (2009)	Denmark (2012)
Scope - test applies to products with at least one of these services	Voice access, SBB, SFBB	Voice access, SBB, SFBB	Voice access, SBB	Voice access, SBB, SFBB	Voice access, calls, SBB, SFBB	SBB, SFBB	Voice access, SBB, SFBB	SBB
Pre-notification of new offers?	Yes	Yes	Yes (but only for residential offers)	Yes	Yes	No	No	No
Network modelled (EEO/ REO/ SEO)	EEO	Voice: EEO BB: EEO/SEO	EEO	SEO - 10.5% market share	SEO - 25% market share	EEO	EEO	REO (but will use EEO for network downstream costs)
Degree of aggregation (portfolio or product-by-product)	Combinatorial test: i) Portfolio: LRIC in non-SMP retail markets; LRIC+ in SMP retail markets	Combinatorial test in competitive areas and product by product test outside competitive areas:	Combinatorial test: i) portfolio test ii) product-by-product test	Product-by-product test	Combinatorial test: i) Portfolio: ATC ii) Product-by-product: LRIC	Combinatorial test: i) Portfolio: ATC ii) Product-by-product: AAC	Product-by-product test	Combinatorial test: i) Portfolio ii) Product-by-product:
Cost standard (AVC/ LRIC/ LRIC+/ ATC)	ii) product-by-product: SRIC/AVC	i) portfolio (inside competitive areas) and product by product outside competitive areas: ATC ii) product-by-product (inside competitive areas): ATC for broadband & LRIC calls	LRIC (FAC when LRIC estimates are not available)	LRIC+ (ATC when LRIC+ estimates are not available)	BU LRIC+ estimates used for network downstream costs		LRIC	LRIC
Scope of the portfolio	One for each product family – separate for SBB & SFBB	One for each product family – separate for SBB & SFBB	Three portfolios: voice-only, triple-play offers and fixed-mobile bundles	All products	One for each product group (single/ dual / triple play)	All broadband products		All SBB products
For which subscribers?	New	Existing + new	Existing + new	Existing + new	Existing + new	Existing + new	Existing + new	Existing + new

	Italy (2010)	Ireland (2013)	Spain (2013)	Greece (2011)	Croatia (2014)	Austria (2013)	Netherlands (2009)	Denmark (2012)
Profitability approach	Forward-looking: DCF for portfolio test and 12 month period forecast for individual test	Forward-looking: DCF for broadband and voice access +Retrospective checks	Forward-looking: DCF for Individual test Retrospective for portfolio	Forward-looking: DCF for new services and period by period for stable services	Forward-looking: actual costs and revenues but possible efficiency improvements are considered	Forward-looking: 1 year ahead forecasts +Retrospective checks	Retrospective	
Timing of the portfolio test	Applied once a year	Pre-notification	Applied every six months	Applied once a year	Updated every six months	Applied once a year		Applied once a year
Average customer lifetime (ACL)	Copper: 2 years NGA: 3 years	SMP operator's ACL	27 months	Based on churn rate in the market		1 year	3 years	4 years
Relevant wholesale network input (WNI)	Blended WNI based on lines in LLU areas	Blended WNI inside competitive areas WLR+bitstream outside competitive areas	LLU in unbundled exchanges WLR+bitstream in the remaining exchanges	Lowest-cost input (LLU, bitstream, WLR)	Blended WNI based on actual usage	LLU, bitstream		
Treatment of TV services	Exempted from the individual test but included in the portfolio test at their LRIC	Included at their LRIC	Included at their LRIC (FAC when LRIC estimates not available)		Included at their ATC for product groups and LRIC for individual products	Excluded - Retail prices are assumed to be set at costs	Included at their LRIC	Excluded from the individual test but included in the portfolio test at their LRIC

Source: based on Agcom (2010), 'Allegato 1 alla Delibera n. 499/10/CONS', 22 September; Agcom (2013), 'Allegato A alla delibera n. 604/13/CONS', 28 October; ComReg (2013), 'Price Regulation of Bundles Offers', Decision D04/13, 8 February; CMT (2013), 'Revisión de la metodología para el análisis ex ante de las ofertas comerciales de Telefónica de España, S.A.U. y de determinadas obligaciones impuestas en el marco de los mercados 1 y 5 de la recomendación de mercados', Anexo 1 MTZ 2012/2259, 30 May; EETT (2010), 'Καθορισμός Μεθοδολογίας Και Γενικές Αρχές Μοντελου Εξέτασης Τών Οικονομικών Προγραμμάτων Μεμονωμένων "Η Και Συνδυαστικών Υπηρεσιών Τών Επιχειρήσεων Με Σημαντική Ισχύ Στην Αγορά"', July; HAKOM (2014), 'METODOLOGIJA TESTA ISTISKIVANJA MARŽE', March; TKK (2013), 'Entwurf einer Vollziehungshandlung nach Durchführung eines Verfahrens nach § 128 TKG 2003', M 1/2012-104 & M 1.2/2012-67, 24 June; OPTA (2009), 'Beleidsregels inzake gedragsregel 5', Policy guidelines, May; Danish Business Authority (2012), 'Engrosmarkedet for fysisk netværksinfrastrukturadgang (marked 4) - Markedsafgrøelse over for TDC samt markedsafgrænsning og -analyse', 16 August.