TalkTalk reply to BT's FAMR response

Non-confidential

11 December 2013

1 Summary

1.1 This paper is the first part of TalkTalk's comments on BT's response to the Fixed Access Market Review ('**FAMR**'), dated 30 September 2013 regarding prospective margin squeeze regulation which Ofcom proposes to apply to superfast broadband ('**SFBB**') products.

1.2 TalkTalk believes that BT's submissions on margin squeeze regulation are unjustified and have no meaningful evidence to support them. Our responses to BT's key points are as follows:

- *The profitability of TalkTalk and Sky's fibre broadband products is of little relevance*—BT repeatedly argues that there is no margin squeeze since its competitors are able to sell SFBB profitably. However, this is not a relevant point. The retail prices which BT's downstream competitors need to set for their SFBB products to have a positive margin are such that BT has been able to take the vast majority of connections over the Openreach network. Moreover, BT has presented no evidence that it is earning positive margins on its retail SFBB products, which is the central element of a margin squeeze test. We continue to believe that BT would currently fail an appropriately applied margin squeeze test on many of its SFBB products.
- *Ofcom is providing sufficient regulatory predictability through its current approach*—BT argues that it has undertaken high risk investment in fibre, and that any regulation imposed by Ofcom would place further investments in jeopardy, as it requires regulatory certainty in order to be able to undertake investments. However, wholesale price caps can be adapted to reflect the risk borne by BT when it invested in fibre roll-out, and there is little further investment to come. The vast majority of future investment in the fibre market will be in customer acquisition, and will be undertaken by retail firms such as TalkTalk and Sky.
- *Margin squeeze protection must be applied to all elements of bundles, including pay TV*—BT argues that margin squeeze protection should only be applied to products which do not include TV, as Ofcom is not sufficiently aware of issues in the triple play market to impose regulation. We believe that Ofcom is well aware of issues in the triple play market, and that any margin squeeze protection which did not encompass triple play products would be rendered ineffective. One of the key ways in which BT is currently margin squeezing is by giving expensive premium sports content to its customers at no additional price. BT does not, as it alleges, have any disadvantage in pay TV which it has not brought on itself by ineffective management.
- *Margin squeeze regulation should be applied on a product-by-product basis*—BT argues that if margin squeeze protection is put in place then it should be applied to all double play products as a whole. However, in TalkTalk's view, adopting such an approach would make margin squeeze regulation less effective, by enabling BT to game the regulatory system and by making it impossible to apply margin squeeze protection on a genuinely *ex ante* basis.

- *Margin squeeze regulation should not require an effects-based test*—BT argues that BT should only be required to adjust its margins on its product(s) if it is shown that it has an actual negative effective on consumers. Such an approach would likely take months or years meaning that if BT's proposed approach is adopted, margin squeeze regulation would effectively be neutered. In any case, the purpose of *ex ante* regulation is to promote competition by proactively preventing anti-competitive behaviour and not, as BT suggest, only to prevent anti-competitive behaviour after its detrimental effects have been inflicted on consumers.
- *Ofcom should regulate GEA-GEA migration charges*—BT argues Ofcom should not regulate the GEA-GEA migration charge. Aside of being starkly self-serving in reducing competition and so protecting BT Retail's position, BT does not appear to understand that Ofcom's duty is to promote competition rather than promote a particular technology.

1.3 We believe that it is imperative that effective margin squeeze regulation is put in place in order to limit BT's ability to abuse its dominant position in the upstream market for wholesale SFBB inputs. Such regulation will probably be a transitional arrangement, pending a move to wholesale price regulation at a suitable point in the next few years. If effective margin squeeze regulation is not put in place now, BT will leverage its dominance in the SFBB market from wholesale to retail level leading to significant consumer detriment. Even if effective wholesale regulation is introduced at a later date, it will be very difficult to bring the market back to a competitive structure within a reasonable timeframe, as consumer switching costs will lock in market shares, and as some firms may have exited the market. Thus consumer harm will persist well beyond the period of lax regulation.

1.4 BT's monopolistic goal is supported by its behaviour in the market for sports rights. BT is bidding for sport and including the content in its packages to enhance its margin squeeze and as a weapon to attack BSkyB. Other ISPs, including TalkTalk, are being caught in the crossfire of BT's predatory bidding and below-cost pricing for premium sports channels.

1.5 The remainder of the document is structured as follows:

- Section 2 responds to BT's submissions on margin squeeze regulation. Section 2.0 firstly sets out the market context for SFBB products, and section 2.1 considers how margin squeeze protection could be operationalised in practice.
- Section 3 then covers issues related to SFBB, in particular future regulatory policy and GEA-GEA migration.

2 Margin squeeze regulation

2.0 Market context in the SFBB market

2.1 BT's statements in its 30th September response regarding the background to the SFBB market are at best seriously misleading. This section sets out TalkTalk's response to those points.

2.0.1 The number of CPs providing SFBB services is of no meaningful relevance

2.2 At §3 of its response, BT cites that *'around 80 CPs are now delivering superfast broadband to their customers over Openreach's fibre infrastructure. 17 of these purchase directly from Openreach, with the rest buying their wholesale inputs from CP customers of Openreach. This environment gives end-users a wide choice of fibre provider'*.

2.3 This argument is of no relevance to whether margin squeeze regulation is necessary or should be applied. Direct and indirect purchasers of generic ethernet access ('**GEA**') in the end are all constrained by the wholesale price set by Openreach (which is an input cost for all CPs operating over BT's network), and by the retail price set by BT Retail (as the largest retailer of SFBB over BT's network). As such, direct or intermediated purchase of wholesale SFBB has no impact on market dynamics.

2.4 The total number of providers is also of no real relevance. It is very common in monopolised markets to have a 'competitive fringe' of small niche suppliers alongside a monopolist with a market share which provides it with dominance or even super-dominance. It is far more instructive to consider BT's current and prospective market share when considering its level of downstream market power.

2.5 In a similar vein, at §§5, 6, 20, and 311(a) BT points towards TalkTalk and Sky offering SFBB products and promoting them (in TalkTalk's case, only passively on our website). We do not consider that this offers any useful evidence for Ofcom's consideration.

2.6 That rivals merely offering products imposes no meaningful competitive constraint on a nascent retail monopolist such as BT. Rather, TalkTalk and Sky's products would need to win sufficient market share (at a positive margin) to force BT to amend its retail strategy. Given the very low market shares of TalkTalk and Sky (less than 15% combined on a stock basis), there is no sign of this happening.

2.0.2 BT's share of on-net connections is consistent with retail dominance

2.7 At §4, BT states that:

> *An increasing proportion of the orders for new fibre connections over the Openreach network are now placed by CPs outside the BT Group... We expect CPs to continue to aggressively market fibre-based broadband services and the retail*

market to be increasingly competitive... This trend is set to accelerate as TalkTalk and Sky ramp up their active marketing of fibre-based services.

2.8 Contrary to this assertion, BT's latest quarterly results provide compelling evidence that it is moving towards a position of dominance in the SFBB market. In the presentation of those results, BT sets out that in the quarter to the end of September 2013, BT Retail '*added 195,000 retail fibre customers and now [has] around 1.7m*'.[1] This can be compared to figures from Openreach, which stated that *'we achieved 316,000 net fibre connections in the quarter, an increase of 70%, helping to bring the number of homes and businesses now connected to over 2m*'.[2]

2.9 That is, BT's latest results set out that it has a 'stock' market share (of existing connections) in the region of 85%. Its 'flow' market share (of connections in the quarter) was around 62%. Both of these figures are consistent with dominance. As the European Court of Justice has stated in *AKZO*:[3]

> *With regard to market shares the Court has held that very large shares are in themselves, and save in exceptional circumstances, evidence of the existence of a dominant position. That is the situation where there is a market share of 50% such as that found to exist in this case*.

2.10 As such, BT's comment at §4 of its FAMR response that '*an increasing proportion of the orders for new fibre connections over the Openreach network are now placed by CPs outside the BT Group. In recent weeks, the percentage of net fibre additions attributable to non-BT CPs has almost reached [✂]*' is thoroughly disingenuous.[4] Given that the date of BT's submission to Ofcom was 30 September (the same as the last day of the quarter covered by BT's most recent quarterly results) BT must have known that it continued to obtain over 60% of new SFBB connections over the Openreach network.

2.11 A fall in market share from over 90% to over 60% is of limited importance in a competition context. BT has a share of on-net connections which would be consistent with dominance if found to be in a relevant economic market, whether on a stock or a flow basis. Moreover, a 1.7m customer base cannot be considered negligible. For there to be a reasonable prospect of the market shifting to a position consistent with broad competitiveness, BT's 'flow' market share would now likely need to fall below 40%. There is little sign of such a radical shift occurring.

2.0.3 BT's evidence on its rivals' profitability is both flawed and irrelevant

2.12 In its FAMR response, one of BT's key (and oft repeated) themes is its claim that TalkTalk and Sky are making strong profits by selling SFBB products, and the

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[1] BT Group plc, *Results for the second quarter and half year to 30 September 2013*, at page 8.
[2] BT, *op. cit*., at page 10.
[3] Judgement of the Court (Fifth Chamber) of 3 July 1991 – AKZO Chemie BV v Commission of the European Communities
[4] A similar point, in near identical terms, is also made by BT at §53 and §66

inference that BT seeks to draw from that. In our view, BT's points on this issue are of no meaningful relevance.

2.13 The calculation of whether there is a margin squeeze is on the basis of whether a rival could <u>profitably match BT's product</u> (including the same features, content, marketing, prices etc). The margin squeeze test is not whether downstream competitors can profitably offer their own, differentiated, products. As TalkTalk's product offer is very different from that of BT, the margin which TalkTalk earns on its product is not informative as to whether there is an ongoing margin squeeze.[5] As such, §8 of BT's response is calculated on the wrong basis, and as such is uninformative.

2.14 Second, even if the profitability of a rival's product were relevant (for instance, if the effect of BT's ongoing margin squeeze, rather than its existence, were being considered), BT's information is of little relevance, as it is too partial. Any business can set a price that is profitable. What is also necessary if one is to consider the effect is what market share that rival can achieve and still earn a positive margin. [✂] At the end of September this year, TalkTalk had 142,000 SFBB customers, or 8.4% of BT Retail's 1.7m SFBB customers. This compares with 4.08m total TalkTalk broadband lines, 58.3% of BT Retail's c.7m lines.[6] As such, BT Retail's share of SFBB lines is around seven times higher, relative to TalkTalk, than in broadband as a whole.[7] [✂]

2.15 [✂][8][✂]

2.16 [✂]

2.17 [✂]

2.18 [✂][9]

- [✂]
- [✂]
- [✂]

2.19 [✂]

2.20 As such, if BT is attempting to imply that there are no effects from its ongoing margin squeeze in SFBB, this is demonstrably false. [✂] resulting in harm to both consumers and the wider UK economy.

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[5] For example, [✂] These factors, and others like them, would all need to be adjusted for.
[6] BT Group plc, *Results for the second quarter and half year to 30 September 2013*, at page 8. Figures for September are used as these are the most recent publicly available comparator information from BT.
[7] It should be noted that these figures include SFBB lines. For standard broadband alone, TalkTalk has 3.94m customers, 74% of BT's 5.3m customers.
[8] [✂]
[9] [✂]

2.21 Thirdly, the actual evidence and information that BT presents is seemingly wrong and/ or out of date. At §8, BT presents a table which allegedly estimates TalkTalk's profitability from selling fibre. [✂]

2.22 We also note that this table is before TalkTalk's product refresh, which introduced a new 'Simply Broadband' product at a lower price point, and turned our Essentials product into a triple-play bundle. As such, the information provided in the table is now out of date (and was out of date even at the time that BT submitted its FAMR response to Ofcom).

2.0.4 Ofcom's proposed approach provides regulatory predictability sufficient to incentivise investment

2.23 At sections 2.3.2 and 2.3.3 of its response, BT sets out its position that it will be making significant investments in the future, and therefore that it requires 'regulatory certainty' in order to make the projected investments (for example, §§88, 91).

2.24 Firstly, it is important to note that there is in fact very little additional investment that needs to be incentivised. BT has already deployed most of its commercial roll-out. Most of the publicly funded roll-out is contractually committed. In fact, the only uncommitted investments are minor and relate to incremental developments such as vectoring.

2.25 In any case, TalkTalk does not agree that 'regulatory certainty' is required to make investments. It would be inappropriate for Ofcom to commit now to a future regulatory approach when the nature of a market (for instance, the BT's market share in the market for retail SFBB) is unknown and therefore the need for, and necessary level of, regulation cannot be known. Furthermore, from a legal perspective Ofcom cannot fetter its discretion. BT is therefore asking Ofcom to act in a manner which contradicts Ofcom's legal obligations and duties to set appropriate regulation.

2.26 Rather, we believe that there should be regulatory <u>predictability</u>, in that all parties (both third parties and CPs) can reasonably anticipate Ofcom's decisions on the basis of publicly available information, and that Ofcom takes evidence-based decisions in a consistent and transparent manner. In our view this is different from absolute regulatory <u>certainty</u>, which would lead to an inflexible approach and poor decisions being made, as Ofcom would pre-commit to certain regulatory approaches.

2.27 TalkTalk considers that Ofcom's approach as set out in its various consultations provides considerable regulatory predictability. Ofcom has laid out that it plans to adopt margin squeeze protection as the correct regulatory approach for the period from April 2014, and then is likely, at a suitable future time, to move to full wholesale price regulation of SFBB. This provides sufficient regulatory predictability for Openreach to base its investment decisions on.

2.28 However, it may be that BT is not asking for 'regulatory certainty' in the sense that all market participants are broadly aware of the likely future path of regulatory interventions but rather, that the regulation should remain the same as today for an indefinite period. If this is the argument we tackle it at section 3.0.0 below.

2.0.5 Openreach's future investment is limited

2.29 While BT's section 2.3.2 focusses on the need for 'regulatory certainty' in order for future investments to be made, in TalkTalk's view the likely scale (and indeed consumer benefits) of investment over the next few years is likely to be limited.

2.30 It is clear that all important investment decisions regarding the roll-out of FTTC will have been made before the commencement of the next regulatory period. Indeed, the completion of the commercial roll-out was one of the core reasons given for Liv Garfield's departure from Openreach:

> *...the time is now right to take on a fresh challenge. Our commercial programme to bring fibre broadband to two thirds of UK premises is almost complete, whilst BT's public sector broadband partnerships are making good progress.*[10]

2.31 By April 2014, TalkTalk believes that essentially the entire FTTC roll-out should be committed, with the commercial roll-out broadly completed (and the remainder of the roll-out ongoing) and most of the contracts for BDUK-subsidised roll-out signed. As such, whatever reasonable regulatory approach is adopted should have no effect on roll-out of FTTC.

2.32 [✂] Vectoring as a technology only has a significant impact on speeds for premises which are already able to achieve high speeds due to their proximity to the cabinet. TalkTalk understands that the speed impact is limited for premises over 800m away from the cabinet (i.e., those homes most likely to be unable to obtain true SFBB speeds). It therefore only has a significant impact on those homes which are already likely to be able to attain an SFBB speed sufficient to meet their needs.

2.33 Moreover, we also understand that the cost of vectoring is low, at a few pounds per line. As an investment, it is likely to be dwarfed by customer acquisition costs for retail SFBB customers, such as the cost of new routers and GEA connection charges, investments which will be made by downstream CPs rather than by Openreach. For example, from April next year the GEA connection charge will be £92 per customer; routers suitable for SFBB are likely to be [✂] per router or more. As such, if TalkTalk and Sky were to between them convert 3m of their customers to SFBB over the next period, there would be customer acquisition costs of at least [✂] just in connection and modem costs, before taking into account marketing costs, commissions and introductory discounts. If customers are acquired from other ISPs, the costs would

[10] http://www.btplc.com/News/Articles/ShowArticle.cfm?ArticleID=4AC4548B-F4EE-4FB3-A56F-440A823AD038

likely be higher still. These costs of investment in new customers are likely to be considerably greater than the costs of rolling out vectoring.

2.34 For both of these reasons, vectoring should be a minor consideration in Ofcom's overall regulatory determination, which should not impact upon the much more significant decision of the form of regulatory intervention which should be applied to SFBB.

2.35 Beyond vectoring, BT makes some vague statements about other potential technologies which could in theory be used at some unspecified future point in the network to increase speeds. Ofcom should give no weight to such unsubstantiated potential future developments.

2.1 Operationalising margin squeeze protection

2.1.0 BT's demands for a full effects based test are designed to frustrate regulation

2.36 At §§16-17 of its response, BT argues that any margin squeeze regulation should include a full effects-based test, to avoid "*false positives*" that may "*actually be seen as pro-competitive and good for consumers*". At §267, BT sets out its concern that there might be too great a focus on "*the numbers*" when conducting *ex ante* margin squeeze tests.[11] By a 'full-effects based test' we presume BT to mean that Ofcom cannot reach a decision that BT's pricing of its product(s) causes a margin squeeze, and that margins should therefore be increased, unless and until it was identified that the BT's pricing had actually caused an identifiable detrimental effect on consumers.

2.37 TalkTalk considers that what BT refers to as a full effects-based test would make *ex ante* margin squeeze regulation unworkable and ineffective. BT's demand for such a test is designed primarily not to benefit consumers (who clearly will benefit from neither BT's remonopolisation of the retail market, nor BT's distortive predatory bidding in the market for televised sports rights). Rather, BT will be aware that if Ofcom had to undertake an effects analysis of each of BT's abusive behaviours, the time taken to conduct such analyses would render it impossible to conclude that there was a margin squeeze for at least 1-2 years after the product had been launched; a margin squeeze could therefore be sustained for at least this long before being stopped by regulatory action.

2.38 Competition Act cases, as they are *ex post*, can often make use of market evidence to demonstrate effects including increased market shares for firms adopting exclusionary behaviours, and price rises after rivals leave the market. Clearly, such evidence will not be available for regulation under the Communications Act which occurs before product launch. It will be very difficult to demonstrate actual harmful effects to consumers in practice.

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[11] [✂]

2.39 Indeed, imposing an effects-based test would, in TalkTalk's view, be inconsistent with the core aim of *ex ante* regulation, which is to promote competition as well as to merely prevent abuses of a dominant position. Effects based tests– which by their nature consider harm to consumers– are not capable of promoting competition.

2.40 Adopting BT's proposed approach would therefore mean that Ofcom would be unable to actively promote competition, and would mean that *ex ante* margin squeeze regulation would add little to the protection provided by the Competition Act.

2.41 It is worth recognising that Ofcom's provisional conclusion to introduce margin squeeze regulation is based on a clear 'theory of harm' (i.e. that BT has an incentive to margin squeeze and there exists a clear mechanism whereby margin squeezing can harm customers) as well as empirical evidence that the market is not working effectively today (e.g. BT Retail's persistently very high market share). It is notable that wholesale price cap regulation is (rightly) imposed with only a 'theory of harm' – in most case, Ofcom does not wait for BT to price excessively before it imposes price regulation.

2.42 Moreover, TalkTalk does not consider that it would be overly difficult for Ofcom to conduct the analysis in a manner which avoids false positives (or for that matter false negatives). Ofcom is experienced in conducting margin squeeze assessments, particularly given its ongoing investigation of BT's pricing under the Competition Act. Such experience should help minimise the potential for an incorrect conclusion to be reached.

2.43 What BT is effectively therefore recommending is that Ofcom replaces a possible problem of "*false positives*" with a near certainty of false negatives. If an effects-based test is undertaken after BT has launched a product, then it would likely be 1-2 years before Ofcom was able to complete its regulatory decision-making process and compel BT to change its prices. In the meantime, BT would almost certainly have changed products of their own volition, and as such Ofcom would risk producing regulatory decisions regarding products which no longer existed. There would be no margin squeeze protection in the period until Ofcom issued its decision, even if there was a margin squeeze (which harmed consumer interests) in force.

2.44 We note that BT has not provided any examples of how consumers might be benefitted by a genuine margin squeeze. It is hard to envisage what circumstances there might be such benefits, particularly when the price of the upstream input (GEA) is set well in excess of the competitive level, and the squeeze could therefore be eliminated by reducing the wholesale price to a competitive level.[12] The relevant counterfactual to a margin squeeze therefore appears likely to be that BT reduces its wholesale price, resulting in lower net prices to consumers from other CPs at the same time as eliminating the margin squeeze. Such an outcome is unambiguously pro-consumer and welfare-enhancing.

[12] See Annex 8 to TalkTalk's October 2013 FAMR submission.

2.45 A need to determine the effects of each potential margin squeeze by BT would also have severe resourcing implications for Ofcom. It is well-known that effects-based analysis requires considerable time from skilled staff to make determinations robust to challenge. TalkTalk does not consider that it is reasonable to impose such additional resource demands on Ofcom, given the low benefits of applying an effects based test to BT's abusive pricing.

2.46 We also note that many other EU Member States (for example, the Republic of Ireland) have been able to impose margin squeeze protection without applying an effects based test at the time of each margin squeeze assessment. TalkTalk is not aware of any *ex ante* margin regulation regime that includes full effects analysis.

2.47 Finally, TalkTalk considers that §18 of BT's FAMR response is disingenuous when it states that "*Ofcom therefore must have a clear justification for departing from the established analytical model for considering exclusionary margin squeeze under competition law. BT's view is that Ofcom has not established such a justification in the consultation*". There is clear precedent for the adoption of margin squeeze protection on an *ex ante* basis in other Member States, as set out in TalkTalk's October 2013 FAMR submission. There is therefore no departure from "*the established analytical model*"; *ex post* application of the Competition Act is not an established model for *ex ante* margin squeeze protection.

2.48 Ofcom has undertaken considerable analysis in the course of the FAMR, as set out in the consultation document published on 3 July. As such, TalkTalk considers that Ofcom has amply established a justification for adopting an approach to *ex ante* margin squeeze regulation which does not require a further review of the effects of each individual case where BT is setting an insufficient downstream margin.

2.1.1 The Competition Act does not provide effective protection against margin squeeze

2.49 Contrary to BT's contention at §21, it would not be appropriate for Ofcom to rely solely on the Competition Act to protect the competitive structure, and, therefore, consumers over the forthcoming regulatory period.

2.50 Competition Act investigations are inherently backwards looking in their nature. Not only does BT have to abuse its dominant position before Ofcom can take any action, but Competition Act investigations are very time-consuming and as such BT can continue to abuse its dominant position– or indeed tighten its margin squeeze– while the investigation is ongoing. The dangers of this are clear from BT's behaviour since Ofcom opened its current Competition Act investigation into BT's SFBB pricing. Since that time, BT has both cut its retail prices for SFBB, and bundled BT Sport with its SFBB products at no incremental price.

2.51 As such, TalkTalk considers that there is a clear, separate role for SMP regulation to promote competition and to prevent margin squeezes occurring, rather than to fine BT for its abusive behaviour after the event.

2.1.2 Margin squeeze protection must cover all bundles, including those with pay TV content in them

2.52 On multiple occasions (e.g., at §21, and on several occasions when responding to question 11.5) BT makes the point that it does not believe that Ofcom should apply margin squeeze testing to bundles containing TV content.

2.53 BT's rationale for this repeated assertion appears to us to be confused. Indeed, a close examination of the stated rationale indicates that there is little underlying it other than BT's desire to continue to use sports rights as a means to distort competition in the SFBB market in its favour.

2.54 The first argument made by BT at §21 is that '*entry into the provision of bundles [with Pay TV/content] is not solely contingent on BT's provision of VULA*'. This statement from BT is unclear, and could be referring to two possible assertions. Either:

- BT is attempting to state that entry into triple play bundles is not solely contingent on the supply of VULA, as operators can instead use MPF in order to serve customers; or,
- BT is attempting to state that entry into triple play SFBB bundles is not solely contingent on the supply of VULA, as operators need to use both VULA and have access to TV content and a platform.

2.55 Both of these arguments are irrelevant. As such, it is of no importance which of these points BT is attempting to make; Ofcom should disregard both of them.

2.56 If BT is attempting to state that ISPs can use MPF to compete with VULA, then there is no distinction between double-play and triple-play bundles in this regard. There appears no obvious reason why MPF would be a closer competitive constraint on VULA when it is used to create a triple play bundle rather than a double-play bundle. As such, if BT is attempting to make this argument, then it has already effectively been considered by Ofcom in its proposals, where Ofcom has proposed to impose margin squeeze regulation on SFBB products notwithstanding wholesale price regulation of MPF.

2.57 Conversely, if BT is attempting to state that entry into triple play bundles also requires access to TV content, such a statement, while factually correct, is again utterly irrelevant. Entry into the provision of bundles <u>without</u> pay-TV or content is also not solely contingent upon the provision of VULA. In order to provide double-play SFBB bundles, TalkTalk also requires routers, customer service arrangements, LLU equipment, and a wide range of other services not supplied by BT. This does not mean that margin squeeze cannot occur. It appears BT either does not understand the requirements for a finding of margin squeeze, or is attempting to mislead Ofcom.

2.58 At §269, BT then proceeds to go further than this and makes the demonstrably false statement that "*Ofcom should not seek to constrain BT's pricing of fibre propositions that include Pay TV/ content via margin tests "on the numbers". Competition in the provision in [sic] these services <u>is not driven by BT's supply of VULA</u>"* (that is, unlike at

§21, the word 'solely' is omitted). That this is incorrect can be seen by considering a hypothetical counterfactual in which BT set a consumer price of £40 per month for a particular triple-play bundle, while setting a VULA price of £50 per month. It is clear that BT would then face no competition from Sky or TalkTalk to offer such bundles, as it would be impossible for BT's competitors to match such a bundle. As such, in non-Virgin areas BT would become the monopoly supplier of SFBB bundles. A similar consequence would follow from a refusal to supply VULA to third parties, which would also eliminate competition. As such, it is clearly the case that competition in triple-play SFBB bundles <u>is</u> driven by BT's supply of VULA. BT is either propagating falsehoods to Ofcom on this point, or has drafted its paper in a negligent fashion. Ofcom should reflect this in the weight which it attributes to BT's comments not just on this point but throughout the paper.

2.59 As is stated by Niels, Jenkins and Kavanagh:[13]

> *Margin squeeze is a form of vertical leveraging whereby a vertically integrated company attempts to exploit a position of dominance in an input market to restrict competition in a competitive downstream market...*
>
> *the basic conditions of a margin squeeze are that the company is vertically integrated and dominant in the relevant upstream market such that downstream competitors have a degree of reliance on the company's upstream input.*

2.60 These basic conditions are fulfilled in this case. It is of no relevance whether BT is dominant in <u>every</u> upstream market, which would be needed for it to be important whether entry is '*solely*' contingent on supply of VULA. Rather, it has to be dominant in <u>an</u> input market, vertically integrated into a downstream market, and downstream competitors must have a degree of reliance on the vertically integrated firm's upstream input.

2.61 All of these conditions are clearly fulfilled. BT is dominant in the supply of VULA over its network (with a 100% share of supply). It is the largest downstream supplier of SFBB over the BT network. And downstream competitors such as TalkTalk and Sky have no outside options other than to use VULA. None of these conditions are dependent upon whether the SFBB based bundle is one containing or excluding pay TV or content.

2.62 As such, there is no relevance whatsoever to BT using this as a reason why margin squeeze protection should not be put in place, or should be applied in a lax manner. Ofcom should give no weight to this argument.

[13] Niels, G., H. Jenkins and J. Kavanagh (2011), *Economics for Competition Lawyers*, Oxford University Press, at page 239.

2.1.3 All elements of a bundle must be included

2.63 At §63 and §157 of its response, BT states (in identical terms) that '*we believe all products contained in a bundle should be subject to a consistent regulatory approach to ensure a level playing field*'. TalkTalk agrees with this statement. It is clear to us that there is no strong rationale why any elements of a bundle should be excluded from consideration.

2.64 We consider that it is particularly important that the costs of BT Sport are taken into account when considering SFBB. The primary role of BT Sport is to support BT's goal of achieving dominance in the SFBB market. Furthermore, access to BT Sport (whether via BT Vision, YouView, Sky DTH, or via an internet app) is bundled into every SFBB bundle. As such, if a consistent regulatory approach is applied to all elements of a bundle, then an allocation for the costs of BT Sport would necessarily be included.

2.65 There appears to be little doubt that the primary aim of BT Sport is to support BT's retail SFBB business. Since the launch of BT Sport, there have been repeated statements from senior BT executives regarding the rationale for the large bids for sports rights, including various statements in the last few weeks:

> *"On Sport we always said fundamentally it was about driving broadband first, then fibre.* (Gavin Patterson, Q2 financial webcast, October 31)
>
> *The* <u>*key for us is growing our broadband business*</u>*. We are available on all platforms. If customers do not want to be BT broadband customers, they can pay for the service as well*[14]*.* (Gavin Patterson, quoted on BBC News website, November 9)
>
> "*We've always made it very, very clear that we've invested in sport to build our broadband business*" (Gavin Patterson, BBC News, October 31)

2.66 As such, there can be no reasonable argument that the core aim of BT's venture into sports is to build a stand-alone business. BT Sport is fundamentally about BT's attempt to remonopolise the retail broadband sector. As such, it is at its core another feature or form of marketing for BT's fibre-based broadband packages, and should clearly be taken into account in any margin squeeze assessment in the same way that marketing spend, modems or other features should also be included.

2.67 Moreover, adopting an approach of not considering the costs of some elements of a bundle (whether pay TV, premium sports channels, or anything else) would ensure that there was an inconsistency of approach, whereby SMP regulation could provide *less* protection to BT's downstream rivals than the Competition Act. This would be inconsistent with the aims of sectoral regulation, which is in general to provide greater protection than is given by standard competition law, and so actively promote competition. TalkTalk considers that this is a further reason why the regulatory approach should cover all bundles.

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[14] [✂]

2.1.4 There is no need for Ofcom to conduct a specific review of triple-play packages

2.68 At various points throughout its submission (for example, §267) BT asserts that Ofcom should have conducted a specific review of the triple play market before introducing any regulation which might affect triple-play packages. Such a perspective is both self-serving and inconsistent with BT's conduct in previous regulatory cases.

2.69 The first important point to note is that Ofcom regulates the TV sector, as well as the broadband sector. As such, Ofcom as a regulator is extremely well placed to draw conclusions on triple-play bundles. There have been numerous investigations undertaken by Ofcom into pay-TV in recent years, including a lengthy CAT case in which BT were one of the main participants. It is simply not credible to posit that Ofcom do not have sufficient knowledge of the triple-play market to make decisions that affect it. Indeed, if BT's advice were followed, then the logical corollary would be that Ofcom should not apply regulation of MPF or WLR pricing where these products are used for triple-play bundles. Such an approach would clearly be nonsensical.

2.70 Moreover, in TalkTalk's view the dynamics of the triple-play market are very similar to those of the double-play market. TalkTalk, like BT, has extended its brand from being a supplier of broadband to also offering triple-play packages including TV. TalkTalk now has a rapidly growing TV business, acquiring more new customers in the most recent quarter than BT, Virgin and Sky combined. All of our comments throughout the FAMR have been on the basis that margin squeeze regulation would apply to triple-play packages.

2.71 Furthermore, as outlined above in section 2.1.1, there is no need for BT to be dominant in any other market than that for wholesale supply of SFBB in order to be able to margin squeeze [✂]. There is therefore no need in any case to undertaken any differing assessment of triple-play markets: if BT is able to margin squeeze in double-play SFBB markets, *a fortiori* the conclusion also applies to triple-play SFBB markets.

2.72 Overall, therefore, in TalkTalk's view there is no need for Ofcom to conduct a needless and time-consuming review of the triple-play in order to find out what is already clear: BT has both the ability and the incentive to margin squeeze in the SFBB market, whether the products are double- or triple-play.

2.1.5 The appropriate regulatory approach is to undertake a product-by-product analysis

2.73 At §313, BT states that:

> *Any margin tests should be carried out across BT's portfolio of "dual play" fibre propositions and not against prices for individual propositions and/or offers within the fibre portfolio*.

2.74 An approach aggregating all fibre products together for the purposes of margin squeeze assessment would be inappropriate, would make margin squeeze regulation meaningfully less effective in preventing margin squeezes from occurring, and allow BT to game the regulatory process.

2.75 In particular, [✂]

2.76 In effect, by claiming that there should be a test across all products, BT is claiming that there should be no meaningful margin squeeze assessment of SFBB products until they have been on the market a considerable time and therefore had the opportunity to exclude BT's rivals.

2.77 Furthermore, testing across all products would enable BT to [✂] If BT undertook such a policy on a repeated basis, it could build a reputation sufficient to deter entry. As Milgrom and Roberts say:[15]

> *A firm's decisions about entering or leaving an industry... [are] properly based on its expectations of the profit implications of these various choices. If a rival could influence these expectations, then it could affect the firm's decisions. For example, if an incumbent firm could cause potential entrants to believe that it would be a particularly tough firm against which to compete, it might deter their entry... if preying upon one entrant would deter other potential entrants because they expect to meet the same reception, then we would have another theoretical basis for predatory behaviour.*

2.78 We believe that firms in the SFBB market will generally attempt to differentiate their product offer from one another. [✂] When combined with the necessarily *ex post* nature of an aggregated margin squeeze test, we believe that BT's proposals would leave the way open to adopt nakedly exclusionary behaviour against entrants who threaten to disrupt BT's nascent SFBB retail monopoly, to the long-term detriment of consumers.

2.79 TalkTalk continues to believe that there should be true *ex ante* margin squeeze assessment, involving products being tested prior to launch. We believe that the approach outlined at section 5.2 of the Annexes to our FAMR response remains the most appropriate and proportionate means of preventing BT from abusively excluding its rivals from the retail SFBB market. This involves testing a set of core products whenever there was a material decrease in price or increase in the content of the bundle.

2.1.6 BT does not have any commercial disadvantage in triple-play

2.80 At §301, BT states that it "*is, in fact, at a clear disadvantage to Sky, Virgin and TalkTalk in relation to the range of Sky Sports channels it can provide given the commercial arrangements in place between BT and Sky*". [✂]

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[15] Milgrom, P. and J. Roberts (1990), *New Theories of Predatory Pricing*, in Bonnano, G. and D. Brandolini (eds), *Industrial Structure in the New Industrial Economics,* Oxford University Press, at p.123

2.81 TalkTalk, as a downstream competitor of both BT and Sky in triple-play TV bundles, has been able to secure supply of the full bouquet of Sky Sports channels from Sky. [✂]

2.82 [✂][16][✂]

2.83 [✂][17][✂]

2.84 [✂]

2.85 As such, for BT to state that it has a clear disadvantage on sports channels is simply not credible:

- we believe that BT could secure supply of Sky Sports if it genuinely sought to do so [✂];
- BT itself has a countervailing advantage in sports rights through its aggressive use of BT Sport. [✂]

2.86 BT's argument is self-serving and partial. Beyond its misleading arguments on premium sports channels, BT has identified no reason why it has a disadvantage in triple-play. Indeed, BT's core TV platform is identical to TalkTalk– the YouView platform. We consider that any 'disadvantages' that BT may have are entirely due to BT's management failings, in poor negotiating practices and in failing to unify its Vision and YouView TV platforms. [✂] Ofcom should not intervene to protect BT's incompetent management approach.

3 Ofcom's proposals on related GEA issues

3.0 Future regulatory approach

3.0.0 There will be a need to move towards wholesale price regulation in the near future

3.1 TalkTalk considers that BT's position on the future regulatory approach is almost diametrically opposed to that which it would be appropriate for Ofcom to adopt.

3.2 Throughout its submission, BT avers that the appropriate regulatory approach is to avoid any price regulation of wholesale SFBB for a considerable period of time. For example, at §§23-24, BT states that:

> *We believe it will remain premature to regulate VULA prices for some time and certainly Ofcom should not intervene until BT has at least achieved payback of its investments in fibre.*

[16] [✂]
[17] [✂]

> *Even then, any consideration of the appropriateness of price regulation would need to take account of a number of factors, including the uncertainty in place around demand and supply at the time of the initial wave of investment*.

3.3 BT then goes on to state that "*fibre will continue to be a risky investment far into the future... we have a forward-looking fibre investment roadmap, including vectoring and other developments*".

3.4 BT's submissions in this regard amount to little more than self-interested pleading to be able to earn supernormal profits on offering GEA in perpetuity. BT provides no reason why it should be permitted to reach payback of its investment before any regulation is put in place– indeed, if BT did achieve discounted payback, then regulation (taking into account the earlier supernormal profits) should set a GEA price of zero, reflecting that capex has been fully funded prior to regulation coming into effect. Such a price path, of monopoly prices followed by zero prices, will yield much lower consumer welfare than a smoother price path which allowed BT to recover its cost of investment, including a suitable return on capital, over an appropriate period.

3.5 BT is in fact asking to be permitted to earn supernormal rates of return on an indefinite basis, due to its view that this is required to incentivise investment. If this is BT's core argument, it is economically illiterate. Companies will undertake investment as long as their (marginal) rate of return on the investment project under consideration is at least equal to their (marginal) cost of capital.

3.6 As such, if GEA were to be price regulated by Ofcom, then BT would have sufficient incentives to invest in vectoring or any other development. By investing, it would be able to earn returns in line with its cost of capital, which should make it profitable to undertake the investment. Indeed, the volatility of returns to investment would be <u>reduced</u> by price regulation– in that sense, wholesale price regulation would increase certainty.

3.7 BT also makes the point that the so-called 'fair bet' principle means that overachievement should not be 'clawed back' after risky investment has been undertaken. Once again, BT is here recommending an incorrect regulatory approach.

3.8 Instead of arguing for unlimited returns, the appropriate approach if a wholesale price cap is set is to assume a cost of capital which reflects any risks which BT took in investing in fibre roll-out. For example, if Ofcom after some analysis were to find that investing in fibre were meaningfully more risky than investing in copper, then the permitted cost of capital could be increased above the cost of capital for Openreach-copper, reflecting these additional risks. Whether such an uplift was set at (for example) 0.5% or 1.0% would depend upon the scale of the additional risks identified by Ofcom. Such an approach would be consistent with regulatory precedent, as well as being in line with economic theory that states that riskier projects will in general have higher internal hurdle rates.

3.9 TalkTalk considers that, given the increasing importance of GEA in the overall broadband sector, there is likely to be a need for wholesale price regulation in the relatively near term. This wholesale price regulation could in principle be either instead of margin squeeze regulation, or in addition to margin squeeze protection.

3.10 There are two important factors which will determine when it is appropriate to impose margin squeeze protection:

- the importance of SFBB in the overall retail broadband sector, in terms of its impact on consumer choice and the number of customers taking SFBB. It is these factors which will lead to BT holding market power and being able to exploit downstream customers; and,
- whether the costs of offering GEA are understood well enough to permit wholesale price regulation to be effectively applied.

3.11 [✂]

3.12 [✂]

3.13 Given this, Ofcom should signal that it will continue to assess whether SFBB should be subject to full wholesale price regulation on its merits from time to time. By doing so, Ofcom will avoid fettering its discretion in any way, and leave the option open to impose regulation as soon as it is appropriate to do so, without any claims from BT that it has breached the principle of regulatory predictability.

3.0.1 4G mobile does not and will not constrain GEA pricing

3.14 BT has once again in its response to the FAMR repeated the canard that it will be subject to increasing competitive constraints from 4G mobile (see §24, §63, §126, §§153-154, §250, §254). This was not true at the time of TalkTalk's initial submissions on Ofcom's FAMR proposals, and remains untrue now. There is no foreseeable point at which 4G mobile telephony will rival fixed line SFBB products in terms of price and quality.

3.15 As set out at §1.13 and §1.22 of TalkTalk's response, mobile internet access (whether 3G or 4G) is not a constraint on BT, and will not be a constraint on BT at any point in the next regulatory period. Rather, mobile internet access is a complementary product to loop-based SFBB.

3.1 GEA migration charges

BT argues at §22 that it is "*premature*" to cut the charges that CPs pay to Openreach for GEA migration, and that "*At this stage, we believe Ofcom should be focusing on supporting increased take-up of fibre rather than measures which would simply increase the churn of existing customers between providers*".

3.16 This argument is again entirely self-serving. As detailed at §2.9 above, BT has a share of over 85% of customers taking SFBB over the Openreach network. Given its high market share, BT has strong incentives to make switching costs as high as possible, so as to entrench its high market share. It is evident that most churn would be likely to be away from BT, given such a high share of supply; BT therefore has incentives to set high GEA migration charges (through its Openreach arm) to increase switching costs and benefit BT Retail.

3.17 As long as GEA charges are set at or above LRIC, there can be no inefficiency from migration charges being too low. [✂]

3.18 Indeed, TalkTalk continues to believe that there is a case for setting GEA migration charges at zero, and cross-subsidising these charges from GEA rentals. Lowering switching costs will increase competition in the retail SFBB market, to the benefit of customers. TalkTalk considers that this increased competition will more than offset any distortion from below cost pricing of GEA migrations, leading to a net consumer benefit.

3.19 BT's suggestion seems to reflect a misunderstanding of Ofcom's duties which include promoting competition – they do not include a duty to increase the uptake of a particular technology such as fibre.