

BT Response to Ofcom VULA Margin Consultation

ANNEX B

BT'S SUBMISSION ON THE APPLICABLE LEGAL FRAMEWORK

1. Introduction

- 1.1 BT considers that Ofcom has not met the legal test for imposing its proposed MST as an SMP condition, regulating the margins that BT must maintain in relation to SFBB based on VULA services.
- 1.2 This Annex to BT's Response sets out why BT considers that: (i) Ofcom has not reached the jurisdictional threshold for imposing its proposed condition under section 87(9) and section 88 CA03¹; and (ii) even if Ofcom had reached the jurisdictional threshold, Ofcom's exercise of its jurisdiction in proposing an ex ante MST condition would not be a proportionate way to address its objectives.
- 1.3 As summarised at section 10 of the Response, BT considers that, taking account of the fact that this Consultation concerns a rapidly developing and highly competitive retail market characterised by bundling of retail offerings incorporating a range of upstream inputs:
 - (a) Ofcom's existing powers to monitor and enforce BT's existing SMP FRAND condition², supported, if necessary, with guidance, its SMP EoI condition and competition law are fully sufficient to address any concerns Ofcom may have as to the hypothetical possibility of exclusionary conduct by BT that could prejudice the future development of competition between SFBB providers and so no additional regulation is necessary; and
 - (b) If, contrary to this primary submission, Ofcom can properly establish that it is justified in adopting an additional regulatory obligation on a precautionary basis, then it has failed to justify the particular form of the proposed MST as against an SMP condition that:
 - (i) uses an EEO standard;
 - (ii) focuses on the regulation of margins for dual play offerings (i.e. excluding the costs of BT TV) and excluding the net costs of BT Sport; and/or

¹ Definitions set out in the Response are applied through this Annex.

² The SMP conditions imposed by Ofcom in the 2014 FAMR Statement include: the obligation to provide VULA on "fair and reasonable terms, conditions and charges" (Condition 1); the obligation that BT must "not unduly discriminate ... in relation to the provision of network access" (Condition 4); and the obligation that BT "must provide network access ... on an Equivalence of Inputs basis" (Condition 5). For present purposes, the term "FRAND" is used to refer to Conditions 1 and 4 and "EoI" is used to refer to Condition 5.

- (iii) to the extent that Ofcom can properly establish that the unrecovered costs of BT Sport should be included in the MST, gives full weight to a carefully considered effects analysis in the event of any failure to meet that test.

2. The relevant legal framework for Ofcom's consultation

2.1 The legal basis for the proposed condition, as set out in section 7 of the Consultation, is section 87(9) CA03, sub-section (a) of which allows Ofcom to set "*such price controls as Ofcom may direct in relation to matters connected with the provision of network access to the relevant network*" ("a section 87(9) condition").

2.2 As such, Ofcom's powers are prescribed by Article 13(1) and (2) of the Access Directive ("AD")³ and section 88 CA03. Section 88(1) prohibits the imposition of a section 87(9) condition unless the requirements of section 88(3) are satisfied:

(a) Under section 88(1)(a) CA03, Ofcom may not impose a section 87(9) condition unless "*it appears to them from the market analysis carried out for the purpose of setting that condition that there is a relevant risk of adverse effects arising from price distortion*".⁴

(b) Section 88(3) CA03 sets out what is required in order to find that there is such a risk, in order to justify imposing a section 87(9) condition. Ofcom must identify a relevant risk that BT might:

(i) fix and maintain prices at an excessively high level; or

(ii) impose a "price squeeze";⁵ and

(iii) find that the consequence of such a risk eventuating would be "*adverse consequences for end-users of public electronic communications services*".

2.3 Ofcom has failed to meet these requirements and, as a result, has not reached the jurisdictional threshold for imposing its proposed MST:

(a) Ofcom has not carried out a sufficient market analysis to show that any additional condition is justified, as against effective monitoring and enforcement of the status quo based on (i) the existing SMP EoI condition which ensures that BT Consumer's competitors are able technically to replicate BT Consumer's offerings to the extent that these are based on VULA; (ii) the existing FRAND condition,

³ Directive 2002/19/EC of the European Parliament and of the Council of 7 March 2002 on access to, and interconnection of, electronic communications networks and associated facilities (Access Directive).

⁴ See paragraph 7.6 of the Consultation. Importantly, Recital 27 FD provides that: "*An analysis of effective competition should include an analysis as to whether the market is prospectively competitive, and thus whether any lack of effective competition is durable*".

⁵ Article 88(3) CA03 refers to a 'price squeeze', while we note that Ofcom also uses the term 'margin squeeze' in the Consultation. We consider that there is no difference between the two terms and use 'margin squeeze' in the remainder of this Annex and throughout the Response.

supplemented as appropriate by accompanying guidelines; and (iii) competition law.

- (b) Ofcom has not properly made out the theory of harm that BT could engage in a margin squeeze to the detriment of end-consumers.

2.4 Even if the jurisdictional threshold for imposition of an additional condition had been passed, so that it would be justifiable for Ofcom to introduce an SMP obligation to address a hypothetical risk of a margin squeeze, Ofcom must also comply with the principle of proportionality in the imposition of such a condition, both as a matter of general law under the European Common Regulatory Framework and in the light of the following specific provisions:

- (a) Article 8(4) AD and Article 8(1) of the Framework Directive (“FD”) and sections 3 and 4 CA03 all require that regulatory action by Ofcom should respect the principle of proportionality.
- (b) Section 88(1)(b) CA03, applying Article 13(2) AD, provides that Ofcom may not impose a section 87(9) condition unless it appears to them that “*the setting of the condition is appropriate for the purposes of ... promoting efficiency; ... promoting sustainable competition; and ... conferring the greatest possible benefits on the end-users of public electronic communications services*”;
- (c) Section 88(2) CA03 further imposes a positive requirement on Ofcom to “*take account of the extent of the investment in the matters to which the condition relates of the person to whom it is to apply*”.

3. General considerations in relation to the imposition of section 87(9) conditions

3.1 Before addressing these points in more detail, BT makes the following general observations.

3.2 First, Ofcom's powers to impose SMP conditions under CA03 and Articles 8-13(a) AD – including conditions imposed pursuant to section 87(9) - are to be construed strictly, for a series of reasons:

(a) Specific conditions such as these are derogations from the general position laid down by Article 3(2) of the Authorisation Directive that only general conditions are to be imposed.

(b) This general approach is reinforced by the specific requirements of Article 8(4) AD, which states that conditions imposed must be "*based on the nature of the problem identified, proportionate and justified*" and Article 8(5)(f) FD, that ex ante regulatory obligations should only be imposed "*where there is no effective and sustainable competition and relaxing or lifting such obligations as soon as that condition is fulfilled*".⁶

(c) These principles are also reflected in sections 3 and 4 of the CA03 which set out Ofcom's duties.

3.3 Second, these non-interventionist principles are reflected in Ofcom's own regulatory principles and policy statements, notably:

(a) Regulatory Principle 3: "*Ofcom will operate with a bias against intervention, but with a willingness to intervene firmly, promptly and effectively where required*"; and

(b) the first paragraph of its guidance on how it will conduct impact assessments:⁷ "*The decisions which Ofcom makes can impose significant costs on our stakeholders and it is important for us to think very carefully before adding to the burden of regulation. One of our key regulatory principles is that we have a bias against intervention. This means that a high hurdle must be overcome before we regulate. If intervention is justified, we aim to choose the least intrusive means of achieving our objectives, recognising the potential for regulation to reduce competition.*"

⁶ Directive 2002/21/EC of the European Parliament and of the Council of 7 March 2002 on a common regulatory framework for electronic communications networks and services (Framework Directive).

⁷ Better Policy Making: Ofcom's approach to impact assessment; Ofcom's approach deliberately reflects broader policy objectives of the UK Government to minimise regulation: "*The option of not intervening ... should always be seriously considered. Sometimes the fact that a market is working imperfectly is used to justify taking action. But no market ever works perfectly, while the effects of ... regulation and its unintended consequences, may be worse than the effects of the imperfect market*" Better Regulation Task Force (September 2003).

- 3.4 Third, these principles impose stringent procedural obligations on Ofcom. The Competition Appeal Tribunal (the “Tribunal”) has emphasised the importance of such procedural guarantees in relation to major initiatives of this kind – see, for example, *Vodafone v. Ofcom* [2008] CAT 22, which emphasises that Ofcom’s decision must be able to stand up to “*profound and rigorous scrutiny*”.⁸
- 3.5 Fourth, these points are reinforced by the present context:
- (a) The relevant retail market as defined is both highly competitive and complex, as illustrated in section 4 of the Response. It is characterised by a wide range of highly differentiated offerings. At one end of the spectrum there are basic offerings. At the other end of the spectrum, there are bundles incorporating a range of upstream inputs from wholesale markets with very different competitive conditions. The major retail competitors to BT, in particular Virgin, Sky and TalkTalk, have strongly differentiated market products and in some cases have significant market power on related markets, notably the entrenched dominant position of Sky in a number of markets connected with the supply of Pay TV content (and the upstream market or markets for CPSCs). Likewise, Virgin is the leading retail competitor for SFBB and is not dependent on BT for inputs to its retail service.
 - (b) Against this context – a complex and competitive retail market with diverse, successful competitors – Ofcom must provide clear evidence to support its view that there is a material risk of BT using its SMP on the wholesale market defined by Ofcom in the FAMR (i) to exclude actual or potential competitors in the supply of SFBB; and (ii) to cause material harm to SFBB customers either during the 2014 to 2017 market review period, or in the next, to the extent that it results from actions during this period.
- 3.6 Finally, there are specific regulatory principles that have been recognised by the EU Commission and BEREC, and by the UK Parliament, that provide important additional context for these issues: see section 10 below.

⁸ Paragraph 36. In making this assessment the Tribunal will adopt a more intensive standard of review than in judicial review. Ofcom must therefore adopt an assessment with appropriate care, attention and accuracy so that their results are soundly based and can withstand the rigorous scrutiny that the Tribunal will apply. See also paragraph 164 of *Hutchison 3G UK Ltd v Office of Communications* [2008] CAT 11.

A. OFCOM HAS NOT MET THE STATUTORY REQUIREMENTS OF SECTION 88(1)(A) AND (3) FOR THE IMPOSITION OF AN ADDITIONAL SECTION 87(9) CONDITION ON BT

4. Ofcom has not carried out the necessary market analysis required under Section 88(1)(a) and (3) CA03.

4.1 Section 88(1)(a) CA03 authorises Ofcom to impose conditions only where it appears to it “*from the market analysis carried out for the purpose of setting that condition that there is a relevant risk of adverse effects arising from price distortion*”. Fundamentally, Ofcom must justify the imposition of any additional section 87(9) condition on the basis of a specific market analysis which shows a material risk of (i) either excessive pricing or a margin squeeze, leading to (ii) adverse effects on end-users in the retail market.

4.2 Ofcom is already able to address the risk of excessively high GEA prices using the existing SMP FRAND condition; the relevant issue here is therefore limited to consideration of the risk of a margin squeeze. BT therefore submits that the effect of section 88(1)(a) and the existing FRAND condition is that Ofcom is prohibited from imposing a section 87(9) condition unless it is able to demonstrate:

- (a) a risk of BT engaging in an exclusionary margin squeeze on the basis of a credible theory of harm (as supported by a specific market analysis); together with
- (b) a clear likelihood of adverse consequences for consumers of SFBB services;

in each case the risk must be material (rather than purely speculative) and based on evidence which withstands “profound and rigorous scrutiny”.

4.3 Moreover, given that the market analysis must be “carried out for the purposes of setting *that condition*” (emphasis added), Ofcom must carry out this risk assessment by comparison with a counterfactual that is based on the *status quo in the absence of that condition*.

The relevant counterfactual

4.4 The relevant counterfactual for the purposes of Section 88(1)(a) and 88(3) CA03 is the regulatory regime that would apply in the absence of the proposed MST. That is, firstly, the SMP conditions that have already been imposed on BT, including: (a) the FRAND condition on the supply of VULA; and (b) the SMP condition which requires BT to supply VULA on an EoI basis, and, secondly, the requirements of competition law binding on BT.

4.5 In each case, the realistic counterfactual must include effective monitoring and enforcement by Ofcom – in particular, Article 10(1) of the Authorisation

Directive⁹ requires such monitoring and enforcement action. Likewise, a realistic counterfactual would include appropriate regulatory guidance as to how the condition would be interpreted in relation to the risk of an exclusionary margin squeeze.

- 4.6 In paragraphs 4.40 – 4.42 of the Consultation, Ofcom considers whether *competition law* would be sufficient to prevent BT from setting the VULA margin in such a way as would lead to a distortion of competition. However, Ofcom does not take into account the fact that competition law would be applied *in conjunction with* the SMP FRAND and EoI conditions such that BT would be subject to *both* ex ante and ex post regulation under CA03 and the Competition Act 1998. BT is already subject to significant regulation and Ofcom’s proposed MST would increase that burden. However, it is clear from the extremely limited explanations of Ofcom’s reasoning in rejecting competition law, as set out in paragraphs 4.40 to 4.42 and 7.6 to 7.7 that Ofcom has not given sufficient consideration to whether its existing package of regulation could continue to achieve its aims.
- 4.7 In assessing the risks of adverse effects on end-users in such a counterfactual, Ofcom should take into account the following:
- (a) In 2010, Ofcom expressly adopted the FRAND condition on the basis that it was “*an appropriate and proportionate mechanism to prevent BT from establishing an inappropriate pricing differential.*”¹⁰ As such, Ofcom took the view that the FRAND condition would deal with the prospect of margin squeeze. This was also the preferred position of Ofcom in the July 2013 consultation.¹¹ There is therefore a significant onus on Ofcom to explain why this reasoning is no longer applicable.
 - (b) Ofcom accepts that there are significant advantages of having a FRAND condition with guidance in terms of flexibility, which mean that it could accommodate changes in circumstances by amending its guidance during the course of the market review period.¹² Ofcom needs to explain why a regulatory approach incorporating such flexibility is no longer appropriate.
- 4.8 However, Ofcom does not present any evidence to suggest that the combination of the FRAND condition, with appropriate guidance, EoI and with the additional substantial deterrent of ex post competition law (in a market characterised by established competitors that have consistently

⁹ Directive 2002/20/EC of the European Parliament and of the Council of 7 March 2002 on the authorisation of electronic communications networks and services.

¹⁰ Paragraph 8.129 of Ofcom’s *Review of the wholesale local access market: Statement on market definition, market power determinations and remedies*, October 2010.

¹¹ Paragraph 11.403 of the consultation on *Fixed access market reviews: wholesale local access, wholesale fixed analogue exchange lines, ISDN2 and ISDN30*, July 2013.

¹² Paragraph 4.53 of the Consultation.

demonstrated that they are willing and able to assert their rights) would no longer be effective to address Ofcom's concerns. As a result, it has failed properly to carry out the very first stage of analysis which would be necessary to conclude that an MST is required at all.

- 4.9 Indeed, although Ofcom does attempt to consider whether the FRAND condition is effective in meeting its objective at paragraphs 4.49 onwards of the Consultation, this is only after it has already concluded that regulatory action is required. Its consideration is therefore merely in order to choose which of its identified options it prefers, as against the baseline of no regulation. FRAND is excluded in large part based on Ofcom's view that it would provide less legal certainty than other options (paragraphs 4.52 and 4.68 of the Consultation), which does not, of itself, imply that it would be ineffective. BT submits that consideration of the existing FRAND condition (properly placed within the package of regulation set out in paragraph 4.4 above) as the proper counterfactual should have occurred as part of Ofcom's analysis of whether there is, in fact, a risk of adverse effects arising for end customers. BT submits that, had Ofcom properly carried out this analysis, it would not have concluded that there is such a risk, and would not therefore have reached the jurisdictional hurdle to impose additional regulation.
- 4.10 It should be noted that, even if Ofcom were to consider that, notwithstanding the terms of section 88(1)(a), it is entitled to assess whether there is a risk of adverse effects arising based on a 'clean slate' of regulation, excluding the existing FRAND condition, BT submits that such analysis (based on the combination of the FRAND condition, the EoI condition and ex post competition law) would in any event need to be undertaken as part of Ofcom's evaluation of whether its proposed MST is proportionate (see further section 6 below) and so Ofcom could not evade carrying out this full analysis. This is reinforced by Ofcom's own Impact Assessment guidance which states that the baseline of "no new intervention" on top of existing regulation should be evaluated.¹³ Ofcom has not carried out this analysis at either stage.

The statutory requirements of section 88(3)

- 4.11 In the remainder of this section, BT addresses Ofcom's analysis of each of the two points identified above, namely (i) the ability and incentives of BT to engage in an exclusionary margin squeeze in respect of SFBB; and (ii) the risk of harm to end-users.

Limb 1. The requirement to show a risk of exclusionary conduct by BT

¹³ Paragraph 3.3 of Better Policy Making, Ofcom guidance on impact assessment, "*At the outset we should identify the issue to be addressed and the options available to us. ... We will start by considering the option of not changing the regulatory framework, either by not introducing regulation or by retaining existing regulation. This option – no new intervention – will generally be the benchmark against which other options are judged i.e. what costs and benefits would be incurred additional to those which would be incurred if there were no new intervention?*"

- 4.12 The first requirement under section 88(3) – that Ofcom must, having taken account of the existing market conditions and the regulatory constraints already acting on BT, show a credible theory of harm – is not made out in the Consultation. In order to show an exclusionary ‘theory of harm’, Ofcom would need to show that BT might have both the ability *and* the incentive, during this market review period, to engage in a margin squeeze, i.e. a reduction in margins between wholesale VULA inputs and retail prices for SFBB with a material exclusionary effect for competing suppliers on any relevant retail market.
- 4.13 Ofcom has sought to address BT’s ability and incentive to undermine competition in paragraphs 3.55 to 3.69. But Ofcom’s assessment is largely theoretical and is evidentially supported only by the volume forecasts described in Tables 3.1 and 3.2. Ofcom simply observes that “*BT expects to still be winning a large share of new subscribers at the retail level by the end of the review period*”.¹⁴ On the other hand, Ofcom then recognises, at the beginning of paragraph 3.69 that “*BT winning a high share of VULA-based superfast broadband subscribers could reflect the legitimate rewards of competition.*” However – and making heavy use of the conditional (“might”, “could”, “would”, etc.) – Ofcom goes on to set out a speculative and unevidenced set of circumstances in which BT’s high share of VULA-based SFBB *might* reflect improper use of SMP, such as to justify Ofcom having a legitimate regulatory concern.
- 4.14 BT sets out its detailed criticism of Ofcom’s reasoning in this regard in Section 5 of the Response. However, we simply note for present purposes, as a general comment, that the possibility of BT retaining a substantial market share on an emerging retail SFBB segment does not in itself evidence any material risk that BT will engage in an exclusionary margin squeeze. As Ofcom itself recognises, that outcome is perfectly consistent with effective competition. BT’s submissions on whether it would, in fact, have the ability and incentive to engage in a margin squeeze are set out in paragraphs 5.21-5.26 of the Response. In addition, BT has the following comments on Ofcom’s speculation and contingent concerns, as against the standard of review which it should have undertaken.
- 4.15 First, the characteristics of the market do not support a presumption that BT would have the *ability* to impose a margin squeeze – especially given the constraints BT already faces in terms of existing SMP regulation and competition law. In paragraph 3.57, Ofcom appears to assume that BT would have such an ability, without attempting any analysis of whether this is actually the case. Ofcom bases its conclusion on: BT’s position as a vertically integrated firm; BT’s upstream dominance; and BT’s control over a vital wholesale input for retail competitors, but does not make any reference to the regulatory context in which BT operates and whether this might act to prevent BT from implementing a margin squeeze.

¹⁴ Consultation paragraph 3.64.

- 4.16 Second, Ofcom has not carried out any detailed assessment of BT's *incentives*. Ofcom states in paragraph 3.60 that "*We consider that raising the VULA price while holding retail prices constant, or even having the ability to do this, may be a relatively low cost way for BT to effectively impede retail competitors*" (emphasis added), suggesting that ability to raise prices would in itself be evidence of a risk of distortion to competition, without any further consideration of incentives.
- 4.17 A full analysis of BT's incentives – both on a static basis and on a dynamic basis over the likely course of the market review period – should be carried out. Given the specific characteristics of the market in question, this is not a straightforward task.
- (a) As set out in paragraph 5.25(a) of the Response, SFBB forms part of a complex retail market that differs significantly from the 'plain vanilla' scenario of margin squeeze based on straightforward conditions of supply and demand (as was the case for the markets considered in the *Deutsche Telekom* and *Telefonica* cases).¹⁵ Ofcom would need to carry out a detailed analysis of diversion ratios in order to evaluate whether BT could expect to pick up a profitable number of customers from its competitors given the differentiation between CPs' bundled SFBB offerings.
- (b) Moreover, this differentiation between product offerings means that different CPs may face different patterns of customer demand. BT Retail's downstream competitors are also Openreach's upstream customers. Any attempt to exclude third party competitors at a downstream level would also result in Openreach losing wholesale sales (see paragraph 5.25(c) of the Response). Ofcom has not carried out a suitable analysis of BT's relative profit margins as part of an evaluation of BT's incentives.
- 4.18 Ofcom's analysis of BT's incentives is inadequate given this level of complexity.
- 4.19 Third, Ofcom considered that concerns about BT's ability and incentive were unlikely in the FAMR Statement (see paragraph 5.26 of the Response) and has not set out any reason why this may have changed. As a matter of fact, Ofcom has no evidence that BT has infringed any of its existing regulatory obligations, and such evidence as does exist, including Ofcom's provisional NGFA decision in the recent competition law complaint and investigation, does not suggest a material risk that BT would be likely to change its pricing behaviour within the period of the market review such as would justify Ofcom increasing its regulation from the FRAND condition to an ex ante MST. Ofcom would have plenty of opportunity to review the market again, either in

¹⁵ Case C-280/08 *Deutsche Telekom AG v European Commission*, C-295/12 P *Telefónica and Telefónica de España v Commission*.

2017, or earlier through an interim review of the market under Article 86 CA03 if it considered that there had been a material change.

Limb 2. The requirement to show a clear likelihood of material adverse consequences for consumers of SFBB services

- 4.20 The second jurisdictional requirement under section 88(3) requires Ofcom carefully to consider the position of those categories of end-users that would be likely to be affected by any “margin squeeze” in respect of SFBB.
- 4.21 For this purpose, Ofcom should have considered (i) the general position of actual and potential SFBB customers; and (ii) the different categories of customers and identified that there is a clear likelihood that any of them are likely to suffer material adverse consequences.
- 4.22 Looking at the general position over the period of the market review and on the basis of Ofcom’s own market analysis:
- (a) Actual and potential consumers of SFBB services would be protected from any material adverse consequences by the existing competitive nature of the wider retail broadband market as defined by Ofcom. The basis for this market definition is that traditional broadband will be considered by end-users to be an effective substitute for SFBB over (at the least) the three years covered by the market review (2014 to 2017).
 - (b) Ofcom’s general concern, based on its own market analysis, can therefore only be that, if the regulatory status quo is maintained, then there is a material risk that, *at some time in the future after the next market review*, Ofcom could find that the constraint from standard broadband had significantly weakened and that an exclusionary strategy pursued by BT during the current market review period would have allowed BT to build up a strong and entrenched market position, which could then cause harm to consumers of SFBB. However, such a speculative concern would require strong evidential support if it were to justify additional regulatory action now.
 - (c) Ofcom has not, however, presented such clear evidence. On the contrary, Ofcom’s positive case is essentially theoretical. BT sets out detailed evidence against Ofcom’s assumptions in section 4 of the Response. The wealth of evidence presented by BT reinforces BT’s case that Ofcom has not conducted sufficient market analysis to demonstrate the need for an additional regulatory condition to be imposed on BT to address the hypothetical risk of an exclusionary margin squeeze that might impede competition on a possible future SFBB market. In fact, BT considers that, had Ofcom carried out a proper market analysis taking into account all of the relevant evidence, it would have concluded that the evidence demonstrates that there is no market entry problem that needs to be addressed by the intrusive regulation proposed by Ofcom.
- 4.23 Turning to the position of individual categories of end-user:

- (a) In so far as Ofcom's concerns might relate to the substantial category of end-users who have little or no interest in premium Pay TV services (and in particular those who place a low value on the additional content available on such services), any risk of "adverse consequences" relates to the possibility that suppliers of such consumers may not be able to compete with BT if BT were to reduce its retail margin to a level that made it impossible for rivals profitably to supply such consumers. An assessment of the likelihood of such adverse consequences would need to exclude any costs incurred by BT in seeking to compete on the premium Pay TV market.¹⁶
- (b) BT submits that any assessment of likely "adverse consequences" for end-users of broadband services should take into account *all* of the effects on those users in order to judge whether they are worse off overall (i.e. whether the adverse effects outweigh any associated positive effects). For instance, for those end-users that are also actual or potential users of Pay TV services in both the short and the long term, any assessment should consider potential effects in relation to the Pay TV markets, i.e. (i) to take account of the market power of other suppliers, notably Sky on the wholesale market for the supply of CPSCs; and (ii) to balance theoretical concerns over the effects in relation to SFBB against the positive effects gained by consumers through BT competing on the market for CPSCs. BT considers that broadband customers who value Pay TV services are better off overall as a result of BT being able to compete effectively against Sky in relation to CPSCs. In any event, the legal point for present purposes is that Ofcom has not carried out this assessment – and indeed now proposes an MST that would in practice exclude the possibility of any such assessment under either ex ante regulation or ex post competition law.

5. Conclusion on jurisdictional arguments

- 5.1 In summary, Ofcom has not met the statutory requirements of section 88(1)(a) and 88(3) for imposing a section 87(9) condition. In particular:
 - (a) Ofcom has not carried out sufficient market analysis as required under section 88(1)(a) as to whether there is a risk that adverse effects would arise from price distortion. In this respect, Ofcom has not correctly identified the primary counterfactual scenario against which to analyse whether there is a risk of adverse effects, which is that the existing status quo of ex ante regulation through the FRAND and EoI SMP conditions (supported by ex post competition law) would persist. As a result, it has not met the requirements for imposing an MST at all.
 - (b) Ofcom has not properly shown that BT would have the ability and incentive to impose a price squeeze. Nor has Ofcom set out what has

¹⁶ See Annex B.

changed since its previous consultations that would lead it to a different conclusion as to the need to impose additional regulation.

- (c) Ofcom has not considered the position of actual and potential SFBB customers in order to evaluate whether there is a material risk that they would suffer adverse consequences.

5.2 Given the complexity of the broadband market, the uncertainty of developments in SFBB and the differentiation of products offered by CPs., Ofcom would need to carry out a careful market analysis as to the likely effects on consumers, rather than seeking to impose a burdensome additional regulatory condition based on a speculative and unevidenced concern as to possible future developments. Otherwise, Ofcom does not meet its own anti-interventionist and evidence-based standard.

5.3 Indeed, had Ofcom carried out this analysis, BT believes that it would have reached the conclusion that no additional regulatory condition of MST is justified. In this respect, BT notes that:

- (a) to the extent that Ofcom has concerns that adverse consumer effects might arise at some point *after 2017*, there will be a further opportunity in the next market review to consider whether it is then necessary to introduce regulation;
- (b) in addition, to the extent that there were any material changes giving rise to such concerns *prior to 2017*, which Ofcom itself currently considers to be unlikely, Ofcom could not only exercise its substantial regulatory powers under the existing regime (i.e. the FRAND condition, EoI and/or competition law), but, also, Ofcom has a safety net, in that if there were material unforeseen changes between now and 2017, it could potentially carry out an additional review in order to impose remedies within that period under Section 86 CA03.

- B. EVEN IF OFCOM HAD CLEARED THE JURISDICTIONAL THRESHOLD FOR IMPOSING AN ADDITIONAL REGULATORY CONDITION, ITS CURRENT PROPOSAL FOR AN MST IS NOT PROPORTIONATE TO OFCOM'S OBJECTIVES.**
- 6. The proposed MST condition does not satisfy the principles of proportionality or the statutory requirements of section 88(1)(b) and (2).**

Introduction – the proportionality requirements to be taken into account by Ofcom in setting a section 87(9) condition

- 6.1 Even if Ofcom had carried out a sufficient market analysis to justify the imposition of an additional section 87(9) measure for the purposes of section 88(1)(a) and (3) CA03, Ofcom must still ensure that any such measure is proportionate to its objectives, i.e. to ensure that BT cannot use its SMP in the WLA market to set the VULA margin over the period of the market review such that it causes retail competition in SFBB to be distorted. BT considers that both the nature of the proposed MST and the specific methodology proposed by Ofcom, are excessive and go beyond what is necessary for Ofcom's purposes.
- 6.2 Under Article 8(4) AD, obligations imposed must be "*based on the nature of the problem identified, proportionate and justified*". This is also clear in the expression of Ofcom's general and Community duties in sections 3 and 4 of the CA03, subject to a requirement that Ofcom's regulations do not involve "(a) the imposition of burdens which are unnecessary; or (b) the maintenance of burdens which have become unnecessary."¹⁷ Ofcom's regulatory principles state that "*Ofcom will strive to ensure its interventions will be evidence-based, proportionate, consistent, accountable and transparent in both deliberation and outcome.*"¹⁸
- 6.3 These parameters for Ofcom to act show that Ofcom must have a strong justification for limiting BT's pricing freedom by imposing an ex ante MST. Indeed, the Tribunal stated in the Mobile Call Termination Charges judgment that "*there can be few economic interests connected with the running of a business more fundamental than the ability of that business to determine the prices at which the goods and services it sells are offered for sale*".¹⁹ As a result, the Tribunal considered that SMP conditions that limit that pricing freedom engage Article 1, Protocol 1 of European Convention for the Protection of Human Rights and Fundamental Freedoms²⁰ and can only be imposed in the public interest and with proper regard for proportionality.

¹⁷ Section 6(1) CA03.

¹⁸ <http://www.ofcom.org.uk/about/what-is-ofcom/statutory-duties-and-regulatory-principles/>

¹⁹ *BT plc, Everything Everywhere Ltd, Hutchison 3G (UK) Ltd and Vodafone Ltd v Competition Commission*, [2012] CAT 11

²⁰ Protocol to the Convention for the Protection of Human Rights and Fundamental Freedoms, 20 March 1952.

- 6.4 The requirements of proportionality were also considered by the Tribunal in its *Tesco* judgment,²¹ by reference to the following passage from of Case C-331/88 R v *Ministry of Agriculture, Fisheries and Food and Secretary of State for Health, ex parte Fedesa* [1990] ECR I-4023, paragraph 13:

“By virtue of that principle, the lawfulness of the prohibition of an economic activity is subject to the condition that the prohibitory measures are appropriate and necessary in order to achieve the objectives legitimately pursued by the legislation in question; when there is a choice between several appropriate measures recourse must be had to the least onerous, and the disadvantages caused must not be disproportionate to the aims pursued”.

- 6.5 Paragraph 137 of the *Tesco* judgment identified the following four “main aspects”, that the measure “(1) *must be effective to achieve the legitimate aim in question (appropriate)*, (2) *must be no more onerous than is required to achieve that aim (necessary)*, (3) *must be the least onerous, if there is a choice of equally effective measures*, and (4) *in any event must not produce adverse effects which are disproportionate to the aim pursued”* (emphasis added).

- 6.6 These general requirements of proportionality are reinforced by the specific provisions of section 88 CA03, which impose further statutory obligations on Ofcom in the setting of section 87(9) conditions.

(a) Article 13(2) AD requires that “*any cost recovery mechanism or pricing methodology that is mandated serves to promote efficiency and sustainable competition and maximise consumer benefits*”. This is implemented into UK law by section 88(1)(b), which prohibits Ofcom from imposing a section 87(9) condition unless it is satisfied that those requirements are met.

(b) Moreover, section 88(2) CA03 gives effect to Article 13(1) AD by imposing a positive requirement on Ofcom, in setting a section 87(9) condition, to take account of “*the extent of the investment in the matters to which the condition relates of the person to whom it is to apply*”.

- 6.7 The MST as currently proposed would constitute a stringent and rigid restriction on BT’s pricing freedom, which would:

(a) impose a mechanistic, ‘bright line’ test based only on the numbers and without any analysis of market effect (as required under ex post competition law);

(b) involve a significant tightening of the normal competition law EEO standard; and

(c) cover SFBB bundles which include components based on inputs other than VULA (e.g. BT Sport) where BT clearly does not enjoy SMP and where one of its principal retail competitors, Sky, is dominant.

²¹ *Tesco PLC v Competition Commission*, [2009] CAT 6.

Even if the jurisdictional requirements for imposing an additional regulatory condition on BT's pricing freedom are met, these features of the proposed section 87(9) condition must all be fully taken into account by Ofcom if it is to perform a proper analysis of whether its proposals are proportionate.

- 6.8 Moreover, in weighing up whether it should (i) maintain the status quo or, alternatively, (ii) impose any form of MST (and in particular the specific form of test proposed), Ofcom must take *full* account of the potential adverse effects of further regulatory action. Ofcom's inclusion of the costs of BT Sport within the test mean that such effects relate not only to the competitiveness of the SFBB market at both the retail and wholesale level, but also to the impact on BT and the potential adverse effects on consumers in the premium Pay TV market (see paragraph 8.4 - 8.8 below for more details). Indeed, the scope for a disproportionate and counterproductive regulatory response in such a complex and evolving market has been recognised at EU level if a rigid margin squeeze test is applied in a market characterised by bundled inputs and costs: see the discussion of the application of margin squeeze tests to bundles at paragraph 10.8 below.
- 6.9 The consequence is that the proposed MST would represent an unjustified and disproportionate response to Ofcom's stated objective of preventing retail competition in SFBB from being distorted. The remainder of this section addresses a number of central defects in Ofcom's current analysis and proposals before addressing the key issues of appropriateness, necessity and adverse effects.

Ofcom has not carried out a sufficient impact assessment

- 6.10 Ofcom considers that the Consultation inherently constitutes an impact assessment.²² BT disagrees. In particular, it does not adequately weigh up the costs of the proposal as against the benefits of applying it. The appropriate standard that Ofcom should have adopted in determining the nature of the impact assessment that is required was as set out by the Tribunal in the *Tesco* judgment²³ namely, a standard which requires the decision maker to take more care where the outcome is more uncertain.²⁴
- 6.11 Given that Ofcom is proposing to regulate in a way that risks impacting services which are currently in a downstream market that is competitive and in relation to which developments through to 2017 are highly uncertain, the prospective analysis is self-evidently not a robust one. As such, it is clear that there is a prospect that regulation will itself impose unjustified costs and/or disbenefits. A detailed, rigorous, and careful impact assessment should therefore be a vital step in Ofcom's analysis. Indeed, Ofcom's own guidance notes that "*An Impact Assessment should therefore be a core part of the*

²² Paragraph 2.12 of the Consultation.

²³ *Tesco v Competition Commission* [2009] CAT 6, paragraph 139.

²⁴ We recognise that this was a decision concerned with the standard to be adopted by the Competition Commission in different circumstances, but nonetheless, the principles are equally valid here.

policy-making process, not a bureaucratic add-on. ... in carrying out Impact Assessments, we will be guided by the principle of proportionality. This means that a decision which is likely to have a wide-ranging impact and/or impose substantial costs on stakeholders will have a more comprehensive Impact Assessment than a decision which will have a less significant impact.”²⁵

- 6.12 An Annex to Ofcom’s own guidance on Impact Assessment notes that “Normally the Impact Assessment will be set out in a separate section or annex of the consultation document” (page 21). This contrasts with the approach taken by Ofcom in this Consultation. At paragraph 2.12, Ofcom merely states that “The analysis presented in this document constitutes an impact assessment as defined in section 7 of the Communications Act (CA03).”
- 6.13 The process that should be followed in carrying out an impact assessment is set out in the Department for Business, Innovation and Skills Impact Assessment Toolkit²⁶ as follows: Step 1. Identify the problem; Step 2. Specify desired objectives; Step 3. Identify viable options that will achieve objectives; Step 4. Identify the impacts; and Step 5. Value the costs and benefits and select the best option.²⁷ BT’s submissions on Steps 1 and 2 are included in Section 5 of the Response. In order to ensure that any proposed regulatory measure is proportionate, Ofcom must also ensure that it carries out Steps 3-5 properly, which it has not done.

Ofcom has not identified and considered all viable options that would meet its objectives

- 6.14 The way in which Ofcom has approached the creation of the proposed MST has failed properly to address Step 3 of the toolkit.
- 6.15 In section 3 of the Consultation Ofcom has settled on its regulatory objective (Option 2). In section 4, it then goes on to consider the means to achieve that objective. In paragraph 4.37, cost-based wholesale price regulation is dismissed as an option and in paragraphs 4.40 to 4.42 ex post competition law alone is dismissed as being ineffective.
- 6.16 At this point of the Consultation, Ofcom has formulated a test that meets its SFBB objectives solely by reference to the supply of SFBB services. However, from this relatively narrow starting point, Ofcom proceeds to design the details of a test that ultimately catches a much broader suite of services. In particular, it incorporates bundles of services which contain other service

²⁵ Paragraphs 1.6 and 1.7, *Better Policy Making - Ofcom's approach to Impact Assessment*.

²⁶ Section 2, *Better Regulation Framework Manual - Practical Guidance for UK Government Officials*, July 2013.

²⁷ Ofcom reflects this process in paragraph 5.4 of its Impact Assessment Guidelines as follows: defining the issue we need to consider and identifying the citizen or consumer interest (stage 1); defining the policy objective (stage 2); identifying the options (stage 3); identifying the impacts on different types of stakeholders (stage 4); identifying any impacts on competition (stage 5); assessing the impacts and choosing the best option (stage 6).

inputs (in particular BT Sport) that are themselves inputs from other upstream markets where BT clearly has no market power (and where one of its principal retail competitors, Sky, is dominant).

- 6.17 Paragraph 4.4 above explains that Ofcom has failed adequately to consider the regulatory status quo of the existing FRAND condition, BT's EoI obligations and competition law for the purposes of determining if any additional regulatory obligation is required. Even if, contrary to BT's view, those regulatory protections are inadequate to address Ofcom's concerns, then a proper Impact Assessment would require Ofcom, having provisionally identified as its preferred option a binary 'on the numbers' MST incorporating triple play packages including BT Sport, to consider a range of other less intrusive options in order to assess whether this was the only, or indeed the preferred, option to address those concerns.
- 6.18 Ofcom considers some of the fine detail of the proposed MST in its discussion as to which adjustments to make, but does not properly reconsider the shape of the MST as a whole. These could also be considered as 'stress testing' of the preferred option. They include, inter alia:
- (i) a bright line MST which is based on an EEO test and which is limited to testing only dual play offerings (plus ex post competition law);
 - (ii) a bright line MST which is based on an adjusted EEO test which is limited to testing only dual play offerings (plus ex post competition law);
 - (iii) remedies designed to ensure economic replicability involving (a) a bright line MST which is based on an EEO test assessing both dual and triple play offerings, which is used for screening purposes, and (b) other measures to assess whether the pricing behaviour in question is actually likely to cause significant harm to consumers (plus ex post competition law); and
 - (iv) Variants of any of the above which involve testing on a dynamic and forward looking basis, rather than a static analysis.
- 6.19 Notwithstanding the fact that Ofcom enjoys a measure of regulatory discretion in making its assessments, its own guidelines and practice - particularly given the speculative nature of its concerns and the intrusive nature of its proposed condition - impose an obligation to conduct a comprehensive impact assessment of alternative options.²⁸
- 6.20 Ofcom also fails to evaluate the option of waiting until market developments are clearer before evaluating whether regulation is necessary. Its own guidelines state that "*Another option which it will often be useful to consider is*

²⁸ Paragraph 1.4 of *Better Policy Making - Ofcom's approach to Impact Assessment*.

the ‘wait and see’ option. This means no new intervention immediately, but a commitment to monitoring the situation and reviewing the position at a later time on the basis of further evidence.” In this respect, a ‘wait and see’ approach would not have to mean waiting until the next market review, but could also be keeping the market under observation unless and until a material change meant that Ofcom felt an interim review (under section 86 CA03) was necessary. BT is already subject to significant regulatory and reporting obligations and so Ofcom would have a comprehensive view of its behaviour, and could launch a targeted review at any stage.

- 6.21 In fact, however, the only option Ofcom ultimately considered was more onerous than any of the above options, namely an MST which is based on an adjusted EEO test and which is a bright line, ‘on the numbers’ test for both dual play and triple play offerings – a test which would, if adopted in its current form, pre-empt any realistic role for competition law. Ofcom has not properly discharged its burden to demonstrate why it needs to impose such intrusive regulation now rather than wait to see whether the developments set out in Section 4 of the Response lead, as BT considers to be likely, to maturing and increasingly intense retail competition for SFBB.

Ofcom has not taken into account all relevant factors in settling on its proposal

- 6.22 In essence, having identified its preferred option, by failing then to circle back and consider less intrusive options of the types described above, the Consultation is also deficient in failing to identify the impacts of the proposal, as compared with the impacts of other proposals (Step 4 of the Toolkit).
- 6.23 Ofcom has made only a cursory attempt to identify the impact on BT of imposing the MST, but has not gone to the detail necessary for a measure of this scale and reach. Ofcom’s assessment of its proposed options is set out in paragraphs 3.87 to 3.94 of the Consultation.
- 6.24 As discussed in more detail below, Ofcom’s discussion of the impact on investment is weak. Ofcom considers (briefly) whether there would be an effect on BT’s investment incentives in relation to fibre, but does not consider any effect on its position in Pay TV. For instance, at paragraph 6.175 of the Consultation, Ofcom notes that *“We are mindful that BT’s expansion into premium sports channels is a new venture that is subject to significant short run and long run uncertainty and that our likely approach for calculating net costs adopts a number of simplifying assumptions that give rise to the possibility of error.”* However, Ofcom does not go any further in attempting to evaluate the likely extent of such error and the implications for BT. BT does not consider that it is reasonably open to Ofcom to defer consideration of the implications of the proposed MST for competition on the Pay TV markets – on the contrary, the risk and extent of any adverse impacts on that market caused by Ofcom’s current proposals must be assessed before those proposals are put into effect.
- 6.25 Further detail on the expected impact on BT is set out in Section 8 below. As BT explains in that section, there is a very significant risk that the effect of

Ofcom's proposals will be to raise a significant barrier to entry or expansion on the wholesale and retail markets for CPSCs, contrary to Ofcom's long-standing objectives.

Ofcom has not sufficiently weighed up the costs and benefits of its proposals

- 6.26 Similarly, the approach taken is also deficient in quantifying the costs and benefits of the options in order to weigh them up (Step 5 of the Toolkit).
- 6.27 In evaluating the proportionality of various options, the Toolkit states that “*a qualitative discussion of costs and benefits is a minimum requirement. Also, there should be initial estimates of costs and benefits associated with the different options.*” In relation to the level of scrutiny of the costs and benefits of each option, the HM Treasury Green Book on Appraisal and Evaluation in Central Government makes it clear that a proper attempt should be made to measure the costs. Paragraph 5.76 of the Toolkit notes that “*Costs and benefits that have not been valued should also be appraised; they should not be ignored simply because they cannot easily be valued. All costs and benefits must therefore be clearly described in an appraisal, and should be quantified where this is possible and meaningful.*”
- 6.28 This is relevant, for example, in relation to the assessment of whether to make adjustments to the EEO. By failing properly to take into account the costs and benefits of the different levels at which to set the MST (i.e. as per Options 1 to 3 in paragraph 3.72 of the Consultation), Ofcom incorrectly rejects Option 1 as ineffective, ignoring the relative strengths of BT's competitors. Ofcom correctly notes that “*In practice, different operators have different commercial strengths and weaknesses*” (Consultation paragraph 6.25). However, Ofcom does not go on to analyse these strengths and weaknesses: see 7.11 of the main Response for the detail of BT's complaint under this head.

Ofcom has not met the proportionality requirement that the condition should be appropriate for its aims, or the specific statutory requirements of section 88(1)(b)

- 6.29 In summary, Ofcom's failure to follow the steps for an adequate impact assessment is not just a procedural failure, but also leads to the choice of a condition that is not appropriate for its aims. As summarised above, the principle of proportionality requires that the measure at issue should be “appropriate” to achieve its legitimate objective. In addition, section 88(1)(b) CA03 prohibits Ofcom from imposing a section 87(9) condition unless it is satisfied that the condition is “appropriate” for the purposes of promoting efficiency, promoting sustainable competition and conferring the greatest possible benefits on the end-users of public electronic communications services.
- 6.30 Not only does Ofcom fail properly to identify or to evaluate the regulatory status quo as the primary counterfactual to the proposed ex ante MST (see paragraph 4.4 above), Ofcom does not adequately analyse the *nature* of the behaviour which, if realised, could put in jeopardy the attainment of Ofcom's objectives, which is a necessary precondition for assessing whether its current regulatory proposal is appropriate in these particular circumstances.

- 6.31 Ofcom's failure in this respect is critical, as the problem that Ofcom is seeking to solve - that there would be insufficient margin for another CP to compete in the supply of SFBB - might come about in a number of different ways:
- (a) BT increasing its GEA pricing;
 - (b) BT decreasing its retail pricing for SFBB; or
 - (c) BT keeping its retail pricing for SFBB constant, despite increases in the costs of those services.
- 6.32 Ofcom merely proposes the MST as a blanket approach to cover all of these scenarios.
- 6.33 BT considers that appropriate guidelines setting out how Ofcom would assess compliance with the existing FRAND condition by reference to BT's costs and revenues as well as underlying market conditions could ensure that it would continue to be effective in relation to each of these scenarios (see 6.18 of the Response). Alternatively, a more limited MST (addressing only dual play products and using EEO costs) would also be effective.
- 6.34 However, by including in the proposed MST retail product bundles such as triple play offers, whose overall cost stack is driven to a large extent by inputs that fall wholly outside the regulated VULA inputs, the current proposal makes no allowance for the complexities of cost increases arising from unrelated factors. The regulatory consequences of any such bundle that failed the proposed bright line MST can only sensibly be considered by means of a detailed and nuanced assessment of dynamics on related markets and an overall analysis of the likely competitive effects and effects on retail customers. Thus, the proposed MST would be unduly onerous, particularly in relation to scenario (c) above, and might lead to a failure 'on the numbers' and hence prohibition of behaviour that is economically rational and where there was no actual risk of distortion of competition on the retail broadband market or in relation to the supply of SFBB.
- 6.35 As such, the broad form of MST which is proposed, excluding any analysis of the basis for any increase in BT's costs or any assessment of the impact of any commercial decision to maintain retail prices, is inappropriate to address the behaviours which might feed in to Ofcom's objective.

Ofcom has not adequately taken into account relevant investments as required by Section 88(2) Communication Act 2003

- 6.36 In addition to the requirements of section 88(1), section 88(2), reflecting the terms of Article 13(1), requires Ofcom to take account of the "*extent of the investment in the matters to which the condition relates of the person to whom it is to apply*".
- 6.37 As such, in weighing up the proportionality of its proposed approach, Ofcom must have regard not only to its duty of promoting competition, but also its

duty of encouraging investment and innovation.²⁹ Furthermore, under Article 13 AD, Ofcom must take into account the investment made by BT and the need to allow it a reasonable rate of return on such investment.³⁰

- 6.38 BT's position is that Ofcom's brief assessment of this issue, which is set out in paragraph 7.8 of the Consultation, is wholly inadequate to meet the statutory requirement. Although Ofcom has made a cursory attempt to consider BT's investment incentives for ongoing investment into fibre,³¹ it has ignored its duty to ensure a return on BT's existing investments. This will, in turn, have an adverse effect on BT's incentives for future investment, whether in fibre or in other areas.
- 6.39 Contrary to Ofcom's apparent interpretation, section 88(2) is not limited to effects on "investment incentives": see paragraph 7.8 of the Consultation. Section 88(2) requires Ofcom to take account of "the extent of investment" generally in determining whether or not to impose price controls: BT must be entitled to recover past investments as well as to enjoy appropriate incentives to make future investments. Recital 3 of the Non-discrimination Recommendation emphasises the European Commission's aims to "*promote efficient investment and innovation in new and enhanced infrastructures*". In relation to SFBB, BT has invested £2.5 billion to roll-out SFBB to two-thirds of UK consumer and business premises by the end of 2014.³² As noted in BT's 2014 Annual Report, BT has made this investment because fibre "*can transform lives and is a platform for growth for the whole of the UK*".³³
- 6.40 The extent of recent and ongoing investment by Openreach is set out in paragraph 5.58 of the Response, including investment into vectoring, new network technologies (Fibre to the Remote Node) and increasing the footprint of broadband access. These investments are underway, but are not complete and will have long pay back periods. BT must be entitled to earn an appropriate return on these investments.

²⁹ Section 3(4)(b) and (d) CA03: "*OFCOM must also have regard, in performing those duties, to such of the following as appear to them to be relevant in the circumstances—(b) the desirability of promoting competition in relevant markets ... (d) the desirability of encouraging investment and innovation in relevant markets*". See Consultation, para 3.37. See also the discussion of section 88(2) at paragraph 6.36 above.

³⁰ The last sentence of Article 13(1) AD provides: "*To encourage investments by the operator, including in next generation networks, national regulatory authorities shall take into account the investment made by the operator, and allow him a reasonable rate of return on adequate capital employed, taking into account any risks specific to a particular new investment network project*".

³¹ Paragraphs 3.91-3.94 of the Consultation.

³² Superfast Broadband: Boosting Business and the UK Economy <http://www.btplc.com/Thegroup/BTUKandWorldwide/BTRegions/England/Factsandfigures/Superfast-broadband.pdf>.

³³ BT Annual Report 2014, page 14.

- 6.41 Ofcom’s approach to the issue of investment is inconsistent with the reasoning in the FAMR Statement, where one of the principal reasons for allowing pricing freedom upstream were the investments BT had already made. In the FAMR Statement, Ofcom considered BT’s investment incentives generally. For instance, at paragraph 12.142 Ofcom stated that: “*We recognise that the majority of BT’s commercial investment in its fibre network is likely to be complete by the start of the review period. Nonetheless, it is important to note that this investment was made in the light of the regulatory position previously set out by Ofcom. Adopting a consistent and predictable regulatory approach is important in order to support future investment more generally (not just in fibre) ... We think that the flexibility to set VULA prices can promote investment by BT as it enables it to trial different pricing arrangements in the early uncertain period of NGA development*”.
- 6.42 Furthermore, significant upstream network investment is now being undertaken by BT’s competitors, such as the joint venture between Sky, TalkTalk, and CityFibre, FTTH networks by Hyperoptic (offering speeds of up to 1 GB per second) and GTC and other initiatives by Gigaclear and KPN, among others (see paragraph 4.57 of the Response). In this context, BT needs to be able to invest and innovate in order to continue to compete. Ofcom’s proposed regulation, which could limit the extent to which BT can recoup the costs of investment that has already taken place, risks placing it at a disadvantage for future investment compared to other CPs. Ofcom should take account of such investments and the need to maintain an even-handed approach. It will also discourage innovation by other CPs, such as TalkTalk and Sky, as they are able to benefit from BT’s investment in the UK’s fibre network without having taken on the risk that BT has incurred.
- 6.43 Therefore, in proposing to implement the *ex ante* MST Ofcom must be concluding that the need to provide entry assistance (to address an aim which is based on the premise of a market problem that is not tested and is not certain to emerge at all, and particularly within the current market review period) outweighs important regulatory consistency and investment considerations,³⁴ despite the uncertainty of the development of SFBB and the remoteness of any potential competition issues.
- 6.44 Ofcom accepts that its Option 3 (sufficient margin to allow an operator with slightly higher costs than BT to significantly undercut BT’s retail SFBB offers) would “*introduce perceived regulatory uncertainty, harming future investment incentives*”.³⁵ However, Ofcom is wrong to believe that Option 2 (its preferred approach) would not lead to the same result.
- 6.45 Furthermore, Ofcom’s proposal to include the costs of BT Sport within the MST draws BT’s investment in premium sport content into the factors of which Ofcom should take account. Section 88(2) refers to investment “in the matters to which the [proposed SMP] condition relates”. The condition relates

³⁴ As Ofcom notes, these considerations apply more generally, in addition to fibre in particular.

³⁵ Paragraph 3.94, Consultation.

to, and will have a direct effect on, BT's Pay TV business. Ofcom should therefore give full weight to the extent of the investment which BT has made in trying to build up its Pay TV business, the need to allow BT the opportunity to recover that investment and the impact of its proposed MST on BT's incentives to make further investments in Pay TV.

6.46 Ofcom has not considered BT's investment into Pay TV at all, merely noting that it "*recognise[s] that the launch of BT Sport impacts on competition in the provision of premium sports channels. Insofar as there may be competition problems in the pay TV sector, we consider that these are best considered through separate regulatory action*".³⁶ By including BT Sport within the proposed MST, Ofcom is obliged to take account of the effects on that market as well as on the broadband market at which the Consultation is aimed. At the least, in the context of the longstanding problems in relation to competition in the provision of premium sports channels, it is deeply concerning that Ofcom would not consider the potential harm that could be caused by its proposed SMP condition, as set out in more detail in Annex B, the Compass Lexecon report on *The appropriate economic treatment of BT Sport in VULA margin regulation*.

7. Even if the proposed MST were appropriate in this case, Ofcom has not established that this test is "necessary", nor has it set the test so as to be the least onerous to achieve the regulatory objective.

7.1 Ofcom's proposed approach goes well beyond that necessary to achieve its aim. Despite the uncertainty of Ofcom's predictions about how the SFBB segment will develop (and the fact that Ofcom has recently published its provisional 'no grounds for action' decision in response to TalkTalk's complaint), Ofcom has nonetheless taken an unduly broad approach to evaluating the level of margin that would be necessary to enable competing CPs to operate effectively.

7.2 As noted above, the impact assessment that Ofcom claims to have conducted is materially inadequate in failing properly to assess the regulatory alternatives that would be available either in the form of the status quo (see paragraph 6.17 above) or in the form of less intrusive forms of MST condition (see paragraph 6.18 above), should Ofcom remain satisfied that the statutory requirements of section 88(1)(a) and (3) are satisfied.

7.3 In assessing the broader question of whether the proposed MST goes beyond what is needed to achieve Ofcom's regulatory objectives, BT notes that recital 65 of the Costing and Non-discrimination Recommendation states the European Commission's view that the aim of the "economic replicability" test advocated in that Recommendation (in effect a margin squeeze test) "*should not go beyond that of a market structure with a sufficient number of qualifying operators to ensure effective competition.*"

³⁶ Paragraph 5.87 of the Consultation.

- 7.4 However, Ofcom's adjustments go significantly further than this. As is made clear in **Annex B**, Ofcom's proposal may require a level of margin that is significantly greater than that necessary for a SFBB competitor to reach minimum efficient scale.
- 7.5 This economic analysis reflects the reality of the UK broadband market. As described in section 4 of the Response, this is a highly competitive and strongly differentiated market where BT's principal competitors have developed a range of distinct business models based on different bundled retail offers and pricing structures. In particular, different competitors have targeted their retail offerings at consumers who place a different relative value on different aspects of their bundled offers, and in particular those consumers who do and those who do not value premium Pay TV as part of a triple play offering. As such, BT's competitors do not seek to replicate all of BT's retail offerings. Moreover, BT cannot seek to replicate all of the products offered by its competitors due to its lack of access to Sky's channels.
- 7.6 The design of Ofcom's proposed MST is seriously defective in failing to take this fundamental feature of the market into account. Ofcom's model, and the adjustments that are made under it, appear to reflect an attempt to ensure that BT's competitors can achieve 'perfect' economic replicability of all of BT's bundles in that Ofcom's means of achieving its aim is to ensure that CPs are able "to profitably match BT's retail superfast broadband offers" (paragraph 3.102). It therefore provides BT's competitors with an asymmetric and unnecessary advantage over BT, which is not warranted in order to achieve Ofcom's aim. That approach is not only unnecessary to achieve Ofcom's objective of preserving the competitiveness of SFBB supply - it threatens to distort the effective competition which is currently operating in the broadband market (as well as materially impeding BT's ability to act as an effective competitor on the Pay TV markets: see below).
- 7.7 In summary, Ofcom's unduly onerous proposed MST results from the cumulative effect of Ofcom's underlying modelling decisions (and in particular, the inclusion of the net costs of BT Sport). As set out in sections 8 and 9 of the Response, BT disagrees with each of the key decisions made by Ofcom and, together, the combination of these decisions leads to a MST that is manifestly more onerous than is necessary.
- 8. Even if an MST were in principle appropriate in this case, Ofcom has not set the test in a way that avoids adverse effects on the broadband or other markets.**
- 8.1 The final element of the proportionality test set out at paragraph 6.5 above is whether the proposed MST condition involves adverse effects that go beyond any benefits. BT considers that the imposition of the MST proposed will have a significant adverse impact not only on the competitiveness of the SFBB market but also its competitive position in other related markets. As explained above, Ofcom has not sufficiently taken into account these potential adverse effects on competition.

The competitiveness of the emerging SFBB market

- 8.2 As section 7 above shows, there is a material risk that the proposed MST will confer an unnecessary benefit on BT's competitors by requiring a margin to be maintained at a level that is not needed for effective competition on that market. Such an outcome would be detrimental to competition on both the retail market and, in the longer term, on the upstream market, in that it would deter investment on that upstream market.
- 8.3 These points are explained in greater detail in Annex B. In addition, Ofcom's failure adequately to identify or evaluate the adverse implications for investment on the upstream market have been described at paragraph 6.36 onwards above.

Pay TV

- 8.4 In addition to potential adverse effects on the broadband markets themselves, Ofcom's proposed approach will have an adverse impact on competition in related markets in the Pay TV sector, in particular competition in the provision of CPSCs and, relatedly, for competition in the form of triple play retail offerings.
- 8.5 As Ofcom is aware, BT is in the early stages of establishing a premium Pay TV business built around its BT Sport channels. By including the costs of BT Sport in the margin squeeze calculations and requiring recoupment of costs from current broadband subscribers, Ofcom will severely limit BT's incentives to invest in BT Sport to compete with Sky going forwards, which can only consolidate Sky's position.
- 8.6 As is shown in **Annex B**, the inclusion of BT Sport may not be necessary to provide an effective level of margin for CPs to "ensure effective competition" with BT in SFBB. Its inclusion at all is therefore disproportionate.
- 8.7 However, there is a further objection to the proposed inclusion of BT Sport arising from the fact that it necessarily involves an adverse impact on the competitiveness of the related markets for premium Pay TV and the upstream inputs for such retail markets – in effect, Ofcom is threatening to create a significant regulatory barrier to entry and expansion to BT as against its principal competitors.
- 8.8 To the extent that Ofcom remains of the view that it is necessary to take BT Sport into account at all, contrary to BT's view, then at the very least appropriate weight should be given to the importance of the investment for BT and the potential benefits to consumers if that investment were to lead to a significantly more competitive market for CPSCs.

9. Conclusion on proportionality

- 9.1 For all the above reasons, the proposed MST condition would infringe the principles of proportionality binding on Ofcom:

- (a) Ofcom has not undertaken an adequate Impact Assessment – it has not sufficiently considered regulatory alternatives that also might meet its objectives or conducted a sufficient cost benefit analysis of each of those alternatives.
 - (b) It has not sufficiently considered BT’s investments in SFBB and related markets (in particular, sports content and Pay TV) both in terms of earning an appropriate return on investment and on future investment incentives for the purposes of section 88(2) CA03.
 - (c) The proposed MST condition is neither necessary to achieve Ofcom’s objectives nor the least onerous option. In particular, the adjustments that are included in the test would result in a greater level of margin for competitors than is needed for them to compete effectively with BT. This would provide competitors with a windfall, in what is a highly competitive market in which they are already successfully operating and would cause distortions in the markets affected by the test.
 - (d) As such, the proposed condition risks having significant negative effects on competition both on the broadband market itself and on competition in other related markets.
- 9.2 Overall, these factors are not weighed adequately in Ofcom’s Consultation and they render the proposed VULA margin licence condition disproportionate.
- 9.3 As a final point, BT contends that, even if Ofcom were to consider, contrary to BT’s assessment, a bright line test remains necessary and appropriate in relation to dual play services, there would still be no justification for applying the same methodology to BT TV or when including the net costs of BT Sport. The market conditions on a complex retail market such as the retail broadband market are not such as to justify a pass/fail accounting test as the basis for regulatory action (see paragraph 6.35 above). As such, any failure ‘on the numbers’ that resulted solely from the additional inclusion of BT TV and/or the net costs of BT Sport should therefore require some form of effects analysis as a precondition to any Ofcom intervention. This final submission on proportionality reflects not only a principled economic and regulatory approach but also the policy position of the EU Commission set out below.

10. Additional considerations under EU and UK law

- 10.1 BT relies on two specific features of EU and UK regulatory law:
- (a) The policy positions stated by the European Commission and BEREC/ERG relevant to this issue.
 - (b) The terms of the recent amendments to section 96A CA03 in relation to the prioritisation of competition law enforcement in a regulatory context.

European Commission Recommendations and BEREC Common Position

- 10.2 Section 4A of the CA03 requires Ofcom to take utmost account of all recommendations issued under Article 19(1) FD. BT considers that it has not sufficiently done so.
- 10.3 In particular, the EU Commission and BEREC have provided specific policy guidance on the issue of margin regulation in the context of the latest round of broadband investment. The guidance emphasises both the complexity of the economic issues that are raised in such markets and the close parallel between competition law and regulatory initiatives in this specific area. Both these points are relevant to the issues addressed above in relation to jurisdiction and proportionality.
- 10.4 Ofcom sets out its views of the European Commission recommendations and the BEREC Common Position from paragraphs 7.14-7.51 of the Consultation. Contrary to Ofcom's views, these papers support BT's contentions that: (i) Ofcom should not propose an MST which uses an adjusted EEO measure; (ii) Ofcom should not impose an MST which includes bundled offers but which does not include any analysis as to whether a failure 'on the numbers' would have a discernible adverse effect on competition and (iii) Ofcom should evaluate the profitability of the relevant downstream products on the basis of a dynamic multi-period analysis, such as the discounted cash flow (DCF) approach. BT does not consider that the points addressed by Ofcom adequately reflect these policy statements.
- 10.5 First, the economic replicability test set out in the most recent European guidance, Article 56(a) and Annex II of the Costing and Non-Discrimination Recommendation, shows that an EEO test is appropriate except in limited and specific circumstances. The triggers for adjusting the EEO are:
- (a) that "*market entry or expansion has been frustrated in the past (as shown, for example by past behavioural findings)*". That is not the situation here. Indeed, Ofcom's very recent provisional findings in its Competition Act investigation suggest the contrary; or
 - (b) "*where very low volumes of lines **and** their significantly limited geographical reach as compared to the SMP operator's NGA network indicate that objective economic conditions do not favour the acquisition of scale by alternative operators*" (emphasis added). Ofcom has not demonstrated that this is the case in the UK. There are four significant market players on the retail broadband market. Although, at present, these four competitors are pursuing distinct strategies in relation to SFBB as an element in their overall competitive position, this is not due to objective economic conditions but down to their strategic priorities (see section 4 of the Response); and neither of the two competitors that have to date focused on traditional broadband offerings, Sky and TalkTalk, face any significant barriers to expanding their SFBB presence to achieve sufficient scale to compete effectively.

- 10.6 Indeed, even where adjustments to the EEO are justified (if one of the triggers above is met), they should not aim “*beyond that of a market structure with a sufficient number of qualifying operators to ensure effective competition*”.³⁷ The adjustments to the EEO that Ofcom propose go far beyond what is needed for that limited objective. It is clear that, in the UK broadband market, there is already a market structure with a sufficient number of qualifying operators to ensure effective competition – and indeed, Ofcom’s findings are that the retail market is competitive.
- 10.7 BT’s contention is that the only outcome which would be consistent with having the utmost regard to this part of the Costing and Non-discrimination Recommendation would be the conclusion that no adjustments to the EEO could be justified, or could be shown to be proportionate.
- 10.8 Second, Ofcom proposes an MST based on bundles of products with a binary pass/fail outcome ‘on the numbers’. As Ofcom is aware, the use of bundles as a means of competing on this market is well established and has led to aggressive and highly differentiated retail competition. The ERG report of the *Discussion on the application of margin squeeze test to bundles*, to which the BEREC Common Position BP 49b refers, makes clear that “*on some occasions, the test outcome in isolation may result in an incorrect appreciation of the possibility that a specific offer or group of offers can foreclose the market to competitors... [I]n the case of bundles, the difficulties pointed out in the design of tests means that their sole use as determinants of a MS taking place may not always be suitable. In such circumstances, one may wish to consider other indicators in assessing the likelihood that a MS occurs as a result of the marketing of a specific bundle that has failed the test.*”³⁸
- 10.9 BT considers that the effect of this statement is that NRAs should exercise caution in applying margin squeeze tests involving bundled offers to avoid a clear risk of incorrect infringement conclusions. The ERG recognises that a pure ‘on the numbers’ test could lead to an incorrect assessment of any foreclosure risk. BT considers that the present facts are a vivid illustration of this risk, given the range of inputs that form part of the bundles that are offered on the UK broadband market.
- 10.10 Further, BT notes that Article 56(c) of the Costing and Non-discrimination Recommendation states that NRAs should make use of their powers “*Where the NRA considers that a retail offer which is not economically replicable would significantly harm competition*” (emphasis added). As such, BT considers that a failure of an “economic replicability” test should not lead automatically to regulatory action. In the present complex regulatory context, Ofcom should consider, on each occasion that a failure ‘on the numbers’ occurs, whether that failure would significantly harm competition. The

³⁷ Recital 65, Commission Recommendation on consistent non-discrimination obligations and costing methodologies to promote competition and enhance the broadband investment environment.

³⁸ Paragraphs 111 and 113 of the ERG report of the *Discussion on the application of margin squeeze test to bundles*, ERG (09) 07, March 2009.

current proposed MST does not allow for this, even in relation to triple play offerings, where the risk of a “false positive” is particularly acute.

- 10.11 Finally, in this regard, BT notes that Annex II of the Costing and Non-discrimination Recommendation states that NRAs should evaluate the profitability of the relevant downstream products on the basis of a dynamic multi-period analysis, such as the discounted cash flow (DCF) approach, which is not the approach proposed by Ofcom. In particular, the test proposed by Ofcom will measure the unit costs of BT TV and BT Sport taking a static short term view. The consequences of this, which evidence how this approach is disproportionate, is explained from paragraph 7.28 of the Response.

The relationship between the exercise of sectoral regulation and competition law

- 10.12 So far as the UK domestic regime is concerned, BT notes that Parliament has chosen to emphasise the need for the sectoral regulators to give greater priority to their competition law role. It would not be consistent with this approach for Ofcom to adopt ex ante regulation whose terms and effect were inconsistent with that statutory purpose.

- 10.13 Section 96A CA03 was amended by Schedule 14 of the Enterprise and Regulatory Reform Act 2013 (**ERRA13**) to introduce new paragraphs (5) to (7), which provide:

"(5) Before giving a notification under this section [notification of contravention of condition other than SMP apparatus condition], OFCOM must consider whether it would be more appropriate to proceed under the Competition Act 1998.

(6) OFCOM must not give a notification under this section if they consider that it would be more appropriate to proceed under the Competition Act 1998.

(7) In a case where OFCOM decide that it would be more appropriate to proceed under the Competition Act 1998, they must publish a statement to that effect in such manner as they consider appropriate for bringing their decision to the attention of persons whom they consider are likely to be affected by it."

- 10.14 The explanatory notes to ERRA13 state at paragraph 378:

*"378. The amendments made by Schedule 14 re-frame the existing duties on the sector regulators to consider using their powers under the CA 1998 to deal with anti-competitive practices. Currently, these duties generally require that a regulator may not take the relevant kind of enforcement action in a case in which it decides that a more appropriate way of proceeding would be under its CA 1998 powers. **This means there is at present an implicit requirement for sector regulators to consider the CA 1998 before using their sector powers. Under the amendments made by Schedule 14 there will be an explicit duty on each regulator to consider whether a more appropriate way of proceeding would be under the CA 1998 before using its sector-specific powers. The intention behind this change in emphasis is to encourage***

regulators to turn their minds to the question of whether the CA 1998 route is more appropriate at an earlier stage" (emphasis added).

- 10.15 It is a fundamental principle of administrative law that a public body must not exercise its discretion in a manner that frustrates the policy of an Act of Parliament: *Padfield v. Minister of Agriculture, Fisheries and Food* [1968] AC 997; *Laker Airways Ltd. v. Department of Trade* [1977] QB 643.
- 10.16 As such, it would be an unlawful exercise of discretion for Ofcom to impose an ex ante regulatory condition that would make it impossible in practice for the statutory requirements of section 96A(5) to (7) to be given effect, subject only to the possibility that such regulatory action could be specifically justified as necessary to achieve some overriding policy objective of that legislation or of directly applicable EU law.
- 10.17 It follows that, failing such an exceptional justification, it would be unlawful for Ofcom to impose a regulatory condition, in a field governed by relevant principles of competition law, on a basis that was materially different to the equivalent competition law test. If such a regulatory condition were to be imposed, then any decision to pursue enforcement action for breach the condition would necessarily be taken *without* reference to the requirements of competition law, contrary to the statutory intention. Indeed, it could lead, in circumstances where there is a regulatory condition which has as its intent the same objective as competition law – that is, the prevention of exclusionary pricing behaviour which could distort competition to the detriment of end-users – to the absurd outcome that there is a finding of a clear breach of the regulatory condition (and hence the prohibition of particular behaviour) in circumstances where it was equally clear that, if investigated under competition law, there would be no finding of infringement (and no prohibition of that behaviour) – and yet, in practice, there had been no real opportunity for Ofcom to consider the desirability of using its competition law powers.
- 10.18 For the reasons set out above, BT considers that the proposed MST requirement is in tension with this statutory amendment and with the policy underlying that amendment. The effect of the proposed condition is deliberately to go beyond the requirements of established principles of competition law in two key respects:
- (a) Substantial modification of the EEO standard.
 - (b) Application of a strict “numbers based” margin squeeze test.
- 10.19 BT considers that these factors under both EU regulatory law and UK primary legislation must be fully taken into account by Ofcom in considering whether it can be properly satisfied that an additional section 87(9) condition is justified at all on the particular circumstances of this case and, if it remains so satisfied, whether the proposed MST complies with its obligations under EU and domestic law.