



OFCOM'S FIXED ACCESS MARKET REVIEW

APPROPRIATE SCOPE OF PRODUCTS INCLUDED IN OFCOM'S PROPOSED VULA MARGIN TEST

- 1.1 Ofcom's Fixed Access Market Review consultation document ("the Consultation") proposed the introduction of a constraint on BT's pricing of its VULA products in order to protect against a risk of BT distorting retail competition by setting an unduly low margin between wholesale and retail prices (the "VULA margin").
- 1.2 As noted in Sky's response to the Consultation, the scope of the bundle of retail services against which the reasonableness of the VULA margin is to be tested is a critical issue in the formulation of an appropriate test. In particular, there is a significant risk that the effect of such a test could be undermined entirely by BT bundling VULA-based broadband services with other products – notably pay TV services – which are sold below cost (or at a significant loss).
- 1.3 Sky notes that a comparable issue arose in the context of Ofcom's Pay TV Review. In the Statement concluding that review Ofcom proposed a retail-minus constraint on wholesale charges for Sky's Core Premium Sports Channels ("CPSCs") – a constraint that has distinct similarities to a margin squeeze rule. Ofcom was concerned that there was a "very real risk" that the effect of this constraint could be undermined if Sky was permitted to bundle the CPSCs with non-pay TV products and services downstream (particularly broadband and telephony) and those products then sold at a loss.¹ Ofcom stated:

*"In such circumstances, the wholesale prices that we set out below would enable competition in the provision of pay TV bundles, but may not ensure fair and effective competition in the provision of bundles of wider retail services. Efficient retailers would not be able to replicate Sky's wider bundles. That position could therefore undermine the efficacy of the wholesale must-offer obligation."*²

*"The concern about the exclusion of equally efficient rivals is particularly important, and we believe it is necessary to protect against it. If we fail to do so, there is a very real risk that Sky would be able to undermine the effectiveness of our remedy."*³

*"our rationale for proposing an adjustment is to ensure that Sky cannot undermine the remedy which applies to Core Premium Sports channels by bundling other products with them in a manner that reduces the margin we believe alternative retailers need to be able to compete."*⁴

- 1.4 In response to Sky querying the necessity and workability of Ofcom's proposal during the interim relief hearing before the Competition Appeal Tribunal, counsel for Ofcom stated:

¹ To protect against this risk, Ofcom introduced a mechanism which required Sky to reduce wholesale charges for CPSCs if it sold other products in the bundle (particularly broadband and telephony services) below their long run incremental cost. Such a specific mechanism would be unnecessary in the case of VULA products provided that the VULA margin test includes costs and revenues associated with important products bundled with VULA at the retail level. If BT's pricing failed the margin test, BT would then have flexibility in terms of which price (or prices) it chose to adjust to comply with the test.

² Paragraph 9.76 of Ofcom's Third Pay TV Consultation.

³ Paragraph 9.205, *Ibid.*

⁴ Paragraph 10.262 of Ofcom's Pay TV Statement, March 2010.



“So what they would do, I think, is cut the price of [other non-TV products [telephone and broadband]] below the cost of supplying those other products as a way of making their retail price for the whole package lower, thereby causing difficulty for anyone that is trying to compete with Sky, whether on a stand-alone basis or as part of a triple play package. It is really bringing within the scope of the margin squeeze analysis, if you like, the fact that this TV product is sold with other products, that Sky might cut the price of those other products below cost in order to reduce its retail prices, thereby squeezing the margin that the other retailers have available to them – that is to say the difference between the wholesale price set under the statement and the retail price with which they must compete with the price of Sky as the incumbent operator. So those provisions we say are important...”⁵

- 1.5 Ofcom’s position was endorsed by BT.⁶
- 1.6 Sky notes that these concerns arose in a context in which downstream rivals of Sky would be able, in principle, to replicate the bundles offered by Sky⁷. In the context of BT’s VULA services, there is no guarantee of wholesale supply of BT’s sports content – and to date both Sky and TalkTalk have been unable to secure such supply. The ability of BT to undermine the effectiveness of the VULA margin test via bundling of such content is therefore an even greater concern.
- 1.7 Moreover, the concern about BT undermining the effect of the proposed test arises in circumstances where BT has already adopted a commercial strategy of bundling content with its VULA-based broadband services, and offering that content for free. This significantly reinforces the necessity of including the cost of content bundled with BT’s VULA-based broadband services in the proposed test.
- 1.8 Sky further notes that, in its response to the Consultation, BT argues against the inclusion of other products (particularly pay TV products) in the test. BT’s opposition is surprising, in view of its strong endorsement of Ofcom’s position in relation to the need for a constraint on Sky’s pricing of non-pay TV products bundled with CPSCs at the retail level. BT stated:

“BT submits that Ofcom should adjust WMO prices by the full amount of any loss on any product bundled into pay TV propositions including core premium channels, but should not include any profits on any products bundled into the proposition. The anti-competitive effects of bundling core premium pay TV products with other products only apply to products where a cross subsidy from pay TV to the other product occurs. These are the effects that could undermine the efficacy of Ofcom’s remedy, and why it is, therefore, right to make this adjustment.”⁸ (Emphasis added.)

- 1.9 The joint submission from BT, Virgin Media and TopUpTV stated:

“The Parties consider that Ofcom has correctly identified bundling of retail products by Sky as a potentially significant risk to the effectiveness of its remedy. Access to

⁵ Transcript, 28 April 2010, page 11.

⁶ *Ibid*, page 27.

⁷ This is because downstream rivals would have guaranteed access to both CPSCs and the inputs required to offer broadband and telephony services (whether via self-supply in the case of BT and Virgin Media, or as a result of regulation (e.g. in the case of firms such as TalkTalk)).

⁸ Paragraph 4.2 of BT’s response to Ofcom’s Third Pay TV Consultation.



*premium pay TV content on the basis of reasonable wholesale prices will clearly not suffice to promote fair and effective competition if efficient rival retailers are unable to compete with the bundles offered by Sky because of the way in which Sky is pricing the broadband component of the bundle...The Parties can also see merit in addressing this problem through an ex post adjustment mechanism as proposed by Ofcom”.*⁹ (Emphasis added.)

- 1.10 Accordingly, the arguments put forward by BT in response to the Consultation plainly are inconsistent with the position it took in relation to constraints on Sky's pricing in the Pay TV Review.
- 1.11 In summary, as noted in Sky's response to the Consultation it is plain that not including important products and services bundled with VULA-based broadband products at the retail level in the VULA margin test would afford BT the ability to undermine the purpose of the introduction of that test, and there is a very real risk that this would happen. A similar risk was recognised by Ofcom in the context of the Pay TV Review and an 'anti-avoidance mechanism' put in place to protect against it. BT, at that time, strongly supported Ofcom's recognition of that risk and the anti-avoidance mechanism proposed by Ofcom.

Sky

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⁹ Paragraphs 9.91-9.92 of the joint response by BT, Virgin Media and TopUpTV to Ofcom's Third Pay TV Consultation.