BT's response to Ofcom's consultation document

"Supplementary guidance on assessment of the VULA margin"

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1. Introduction and summary

1. We welcome the opportunity to comment on Ofcom's consultation document, *Supplementary guidance on assessment of the VULA margin*, published on 11 June 2015.

2. The supplementary guidance relates to the announced changes, effective 1 August 2015, in the way BT will provide the BT Sport channels to customers – i.e. BT will begin broadcasting UEFA Champions and Europa League matches and will change the pricing structure for accessing the channels both within broadband bundles and on a stand-alone basis. We welcome Ofcom's confirmation that these changes constitute a material change in circumstances[1] that justify a departure from the standard test set out in SMP Services Condition 14. By "standard test", we mean the application of Condition 14 by reference to the Guidance on assessment of the VULA margin set out in Annex 3 of Ofcom's Final VULA Margin Statement[2].

3. The standard test is a bright-line static test, constructed from 'current' (i.e. relating to the specific month in which margin is being assessed) and historical cost, revenue and volume data, which, among other things, requires defined contributions to be made from newly acquired superfast broadband ("SFBB") customers towards any observed unrecovered losses for BT Sport in the month of acquisition. Should BT fail the standard test, there would be no consideration of the competitive effects of BT's SFBB pricing before Ofcom would find BT to be in breach of the regulatory condition. In particular, application of the standard test draws no distinction between a short term fluctuation in costs or revenues that would have no material effect on competition, an enduring pattern of losses and/or behaviour subjectively intended to result in foreclosure of competitors.

4. Likewise, despite purporting to assess the margin earned across the expected lifetime of newly acquired customers, application of the standard test will take no account of future changes in prices and unit costs, including growth trends in subscriber volumes and revenues for BT Sport that would reduce observed losses over time. The test, as imposed by Ofcom, would also appear not to allow for any assessment of whether any failure of the test was the result of the commercial failure of a particular proposition because customers did not value it sufficiently highly or a fall in sales caused by short term retail initiatives by BT's retail competitors with no change in BT's costs or prices. This is notwithstanding the fact that the test, as an "economic replicability" test, should be designed so that Ofcom intervenes only to prevent "*a retail offer which is not economically replicable* [which] *would significantly harm competition*"[3].

5. BT appealed the test to the CAT in May 2015. This response is without prejudice to our position and arguments as set out in BT's Notice of Appeal and supporting documentation. In this response we address only the specific issues raised by Ofcom's consultation on its proposed supplementary guidance on how it will apply the test in the future.

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[1] As defined by Ofcom in paragraph 6.25, *Fixed Access Market Reviews: Approach to the VULA margin*, 19 March 2015.
[2] Ofcom, *ibid*, Section 6 and Annex 3.
[3] Paragraph 56 (c) European Commission *Recommendation of 11 September 2013 on consistent non-discrimination obligations and costing methodologies to promote competition and enhance the broadband investment environment*

6. However, it is relevant in this consultation to take account of the fact that, ahead of the final VULA Margin Statement, the European Commission requested that Ofcom *"re-visit the design of its proposed ERT in its final measure and to ensure that sufficient flexibility is given to BT to recover the considerable costs for BT Sport over a longer time horizon, in particular in light of uncertainties relating to scale and costs of future auctions."*[4] Ofcom chose not to do so and argued that this was not necessary in the present UK context[5]. Ofcom limited its response to an indication that there could be greater flexibility in the application of the test set out in the Condition if there should be "a material change in circumstances", but it did not specify when or how this might apply in practice. In the Final VULA Margin statement Ofcom merely highlighted that it "***may*** *take increases in future demand into account*" and that depending on the specific circumstances, it "***may*** *consider whether the cost and revenue data used in the compliance assessment is representative of the margin over the ACL*" [bold emphasis added].[6]

7. By accepting that the changes to the BT Sport propositions constitute material changes in circumstances and proposing changes to the way in which the test operates, Ofcom accepts that it should now re-visit the design of the standard test in respect of those changes. To the extent that Ofcom intends to make changes that reflect the Commission's comments, we welcome Ofcom's willingness to reconsider the appropriateness of the SMP obligation that it has imposed on BT.

8. However, it appears that Ofcom's intention is to make only minimal changes to the standard test. The changes proposed in the consultation document are extremely limited and remain insufficient to address fully the European Commission's concerns. Whilst any relaxation of the current disproportionately restrictive test will be welcomed by BT, the flexibility that Ofcom proposes falls well short of what is required to avoid the risk of competitive distortions arising from the standard test as it is presently formulated.

9. The additional costs associated with the UEFA rights BT has acquired for the three football seasons from 2015/16 to 2017/18 are clearly significant and, under Ofcom's standard approach to the treatment of rights costs within the VULA margin assessment, would increase the margin BT must make on newly acquired SFBB customers in each individual month from August 2015. Ofcom's proposals would allow some flexibility – relative to the standard test – around the margin contributions newly acquired customers in a given month should make towards the observed unrecovered losses of BT Sport in the month of acquisition. However, this flexibility would only last for the five month period from 1 August 2015 (i.e. when the changes to the BT Sport propositions are made) to 31 December 2015 (known as the "Deferral Period"). If the flexibility were utilised in the Deferral Period, this may impose <u>additional</u> margin requirements – i.e. over and above those set by the standard test – on newly acquired SFBB customers for each of the following 5 months (known as the "Recovery Period").

10. Such an approach would fall far short of the additional flexibility that Ofcom should have proposed. Ofcom's arguments in support of its proposed approach relies on arbitrary judgements and a very weak evidence base. We are particularly concerned that Ofcom

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[4] European Commission, *Commission Decision concerning Case UK/2015/1692: Wholesale local access at a fixed location in the United Kingdom — Remedies*, 13 February 2015.

[5] Ofcom, *Fixed Access Market Reviews: Approach to the VULA margin,* 19 March 2015, paragraphs 7.137-157.

[6] Ofcom, *ibid,* paragraph 6.25.

has put forward this proposal without properly considering whether there are any other alternatives to its proposed approach which would be a more reasonable and proportionate response. In BT's view, there are better alternatives which would (a) provide BT with a greater degree of flexibility, as the European Commission proposed, (b) minimise the extension of this SMP obligation into unregulated markets and yet (c) still protect the interests of BT's downstream retail competitors and consumers.

11. As we explain in this response, the evidence supports BT's position that it would be more reasonable and proportionate for BT to have flexibility to recover any additional costs associated with the UEFA content over a much longer period. In particular, longer term revenue trends clearly show that [✂].

12. Notwithstanding our fundamental concerns with Ofcom's treatment of the unrecovered losses BT faces in supplying the BT Sport channels in attempting to build a viable, competitive set of channels in competition to Sky, we believe, at the very least, Ofcom should amend the test by extending the period for additional flexibility to at least match the length of the UEFA football rights contract to which the changes relate (i.e. the 36 months to the end of the 2017/18 season).

13. In practice there are a range of possible alternatives that could be used to achieve this and to provide Ofcom with sufficient comfort that BT could not exploit this flexibility to undermine the objective of the VULA margin regulation. For example, the Deferral Period could be extended to cover the entire first season of the UEFA football rights, and the Recovery Period could be extended to cover the second and third seasons. Furthermore, the Recovery Period could be simplified so that any net losses accumulated in the Deferral Period are able to be recovered flexibly over any Recovery Period, rather than requiring rigid monthly contributions on top of those required by the standard test in each month. We are concerned by the fact that Ofcom appears not to have considered other options such as those described in this response or to have considered whether the proposed amendments constitute the least restrictive condition that would address its concerns.

14. The approach which Ofcom has taken in developing this proposal raises concerns for the future. Beyond the specific circumstances considered in this consultation, there remains a need for greater clarity about how BT's SMP obligation will apply on other occasions in the future [✂]. BT needs to know the extent of the constraints imposed upon its commercial behaviour by the SMP conditions imposed on it in advance, as is appropriate under ex-ante regulation. We are concerned that this supplementary guidance sets an unhelpful precedent for how Ofcom may assess other material changes in circumstances. It suggests that any additional flexibility to recover any additional costs of supplying any new products and/or services within SFBB bundles over a longer time horizon will be extremely limited.

15. Furthermore, the proposed change to the standard test, like that test itself, fails to recognise the commercial risks that arise every time BT makes significant changes to its propositions or launches new products. Should a changed or new product suffer a commercial failure then the effect of both the standard test and its proposed modification is to push ***up*** the margin requirement on BT, despite the fact that the product has been proven to be of limited interest to customers at existing prices, which would normally exclude the possibility of a negative effect on competition. Ofcom needs to explain how it would address the vicious circle this would create and this apparent paradoxical outcome of an approach that purports to address risks of distortion to competition.

16. In summary, BT does not consider that the proposed changes to the standard test are sufficient to address the defects in an inappropriately static and restrictive margin test concerned solely with cost recovery. Ofcom's acceptance of the need for such changes so soon after the standard test enters into force illustrates that the standard test is not sufficiently flexible to cope with a rapidly evolving and highly competitive retail market place, or to accommodate future significant product changes and new product launches by BT. However, the very restrictive modification now proposed by Ofcom fails to address the underlying defects in the standard test. BT's view is that only a more flexible test that includes an assessment of competitive effects would be truly future-proof. Such a test would avoid the need for Ofcom continuously to patch up a deficient test design whose rigidity and lack of regulatory certainty amounts to a disproportionate and discriminatory fetter on BT's commercial behaviour.

17. **Overall, we remain of the view that, where proper market analysis discloses a relevant risk of market distortions, a properly formed ex ante economic replicability test could be an appropriate remedy. The limited scope of the proposals set out in this consultation could not achieve that. But within the scope of this document, in summary, we consider that at the very least Ofcom should**

    - **extend and simplify the period over which it grants BT flexibility to recover the additional costs of the UEFA rights to 36 months; and**
    - **provide principled guidance on how it would approach future material changes in circumstances, which must include an explanation of how it would assess a failure of the VULA margin test as a result of a commercial failure of a significantly changed or new proposition and/or falls in sales caused by retail initiatives by its competitors.**

18. Having regard to the fact that Ofcom is now proposing to specify how the standard test should be adjusted in the period between August 2015 and May 2016, a decision by Ofcom to implement its proposal will amount to a measure "*imposing, amending or withdrawing*[7]" the *ex ante* margin squeeze obligation imposed on BT as an SMP remedy. Ofcom is accordingly required to notify the proposed changes to the European Commission pursuant to the Article 7 Framework Directive notification procedure and we invite Ofcom to confirm that it will do so prior to adopting its decision.

[7] Article 7a Framework Directive.

2. VULA margin regulation imposed by the March 2015 Final Statement

The Standard Test

19. Ofcom's proposed amendments set out in this consultation illustrate that the standard VULA margin test is not fit for purpose and operates as a disproportionate regulatory restraint on BT's commercial freedom, having regard to the dynamic and highly competitive market environment in which it is applied.

20. Ofcom's regulatory aim for this regulation is said to be:

    "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 superfast broadband to be distorted by virtue of imposing a price squeeze which has adverse consequences for end users of public electronic communications services."[8]

21. The standard test set out in the April 2015 VULA Margin Final Statement (i.e. the test currently in effect, subject to any future changes pursuant to the present consultation) is a bright-line static test, constructed from 'current' (i.e. relating to the specific month in which margin is being assessed) and historical cost, revenue and volume data, which, among other things, requires defined contributions to be made from newly acquired superfast broadband ("SFBB") customers towards any observed unrecovered losses for BT Sport in the month of acquisition. Should BT fail the standard test, there would be no consideration of the competitive effects of BT's SFBB pricing before Ofcom would find BT to be in breach of the regulatory condition. In particular, application of the standard test draws no distinction between a short term fluctuation in costs or revenues that would have no material effect on competition, an enduring pattern of losses and/or behaviour subjectively intended to result in foreclosure of competitors.

22. Ofcom developed the test against a specific state of affairs said to have existed as of late 2014/early 2015 and to address market conditions for a period of only two years until completion of the next Fixed Access Market Review. Even on Ofcom's case, the specific state of affairs addressed in the standard test holds only until August 2015, which is when there will be the first material change in circumstances with the changes to the way the BT Sport channels are supplied. In light of these changes Ofcom is now re-visiting the design of the test, and the outcome will be a change in the way that BT is required to act in order to be compliant with the SMP services condition 14. Further commercially significant changes to the retail broadband market can be expected in the next two years. It seems likely that Ofcom will have to consider whether those changes also constitute "material change of circumstances" leading to further consultations on yet further changes to the standard test.

23. It is of note that the change consulted upon – and changes in the future – will not relate to the provision of the underlying broadband products, but to products and services included within bundles. Yet the way in which BT chooses to compete in these other product markets, in which there can be no suggestion of retail or wholesale SMP for BT, will determine whether BT fails the VULA margin regulation because all products that are bundled together with fibre broadband are captured by the test. As BT is an entrant in these other product markets and faces much larger competitors (e.g. Sky and Virgin in

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[8] Ofcom, *Fixed Access Market Reviews: Approach to the VULA margin,* 19 March 2015, paragraph 3.131.

the pay TV sector), any new offers relating to these markets may not bring in incremental margin from day one. It is curious that Ofcom regards BT's entry into these markets with concern as it is in these markets that Ofcom is intent on creating more competition.

24. BT has lodged an appeal at the CAT against Ofcom's decision to impose SMP services condition 14 (the VULA margin test) in its current, i.e. standard, form.

25. This response to Ofcom's consultation and the suggestions that BT puts forward are without prejudice to the arguments advanced by BT in its Notice of Appeal and supporting documents. The fact that BT makes recommendations about possible ways forward should not, for the purposes of that appeal, be seen as any form of acceptance of the test in the current form or of Ofcom's decision to introduce it.

Ofcom's response to comments by the European Commission

26. The comments of the European Commission expressed in its letter to Ofcom pursuant to Article 7(3) of Directive 2002/21/EC[9] raised a number of significant concerns regarding Ofcom's static approach (under what became the standard test) to the costs associated with BT Sport. Specifically, the Commission stated that:

    - The considerable costs paid by BT for *"premium content rights available over BT Sport"* are *"a long term investment in a market where BT does not have SMP, where the SMP framework does not apply, and in which BT faces strong competition by other players"*.
    - Ofcom's proposed *"static period-by-period approach looking at a short time interval (six months) in isolation"*:
        i. *"unduly limits .. BT's flexibility to defer the recovery of its costs for BT Sports over a longer period … [and] BT's commercial activity with regards to a market in which it does not have SMP"*; and
        ii. is inconsistent with the approach recommended by the Commission in its 2013 Recommendation, which *"clearly stated that NRAs should evaluate the profitability of the relevant retail products on the basis of a dynamic multi-period analysis"*.
    - The design of the test proposed by Ofcom *"may result in BT choosing to address a failed test by changing its behaviour on a market other than the regulated market, for example by increasing retail prices or reducing costs for BT Sports"*.
    - The proposed test therefore presents a risk that *"Ofcom's regulatory intervention would have a significant impact on non-regulated markets, without necessarily affecting the price of the VULA input"*.

27. In light of these concerns, the Commission states that *"Ofcom will… have to remain vigilant that the application of the test does not have unintended consequences in markets where the application of ex post competition law would be sufficient, or where BT's SMP in the WLA market does not necessarily play a role."* The Commission then specifically *"requests Ofcom to re-visit the design of its proposed ERT in its final measure and to ensure that sufficient flexibility is given to BT to recover the considerable*

[9] European Commission, *Commission Decision concerning Case UK/2015/1692: Wholesale local access at a fixed location in the United Kingdom — Remedies*, 13 February 2015.

costs for BT Sport over a longer time horizon, in particular in light of uncertainties relating to scale and costs of future auctions".

28. In the March 2015 Final Statement, Ofcom chose not to re-visit the design of the test in accordance with the Commission's request. Rather, Ofcom's response to these concerns in its Final Statement considered that there was no justification in the UK context to build more flexibility into the standard test for BT in its recovery of costs related to BT Sport. Ofcom defended this on three main grounds:[10]

    - for its current BT Sport offer, the need to build up scale was less relevant to BT than a stand-alone channel provider because BT offers BT Sport for free to its large broadband base;
    - BT has already had sufficient time to build up scale; and
    - Ofcom's indicative assessment suggested that BT passed the test under Ofcom's "standard" test and was able to fully absorb the costs of BT Sport in the VULA margin.

29. We have a number of concerns with Ofcom's consideration of the Commission's comments in the Final Statement (as reflected in our Notice of Appeal). Furthermore, and among other things, Ofcom's overall position that BT does not require flexibility as we have had time to build up scale appears at odds with Ofcom's stated position in the December 2014 "Review of the pay TV wholesale must-offer obligation" consultation where, for instance at paragraphs 8.21 to 8.22 reference is made to BT being a "relative new entrant" in wholesale sports supply and having a "modest position at the wholesale and retail market level".

30. Nevertheless, in the March 2015 Final Statement Ofcom recognised that there could be material changes in circumstances in future which would require modifications to be made to the standard test.[11] In effect, it indicated that it would assess the extent to which the standard test would need to be changed on each occasion as and when a material change of circumstance occurs.

31. This has left BT in a very uncertain position. There is the suggestion that the test may be relaxed, but no real prior knowledge or certainty of the extent of any such relaxation. Against that backdrop, and with the launch of BT's coverage of the UEFA content impending, BT has had to ask Ofcom to confirm that this is a material change of circumstances and to clarify the extent to which it is minded to relax the standard test in these circumstances.

32. Ofcom's approach is cautious in the extreme. It has stated that *"[a]s a general matter, we consider that allowing BT to defer some of its cost recovery in future periods should be based on clear evidence that the profitability of BT Sport is expected to increase in the future."*[12] As we will show in section 3 below, this is clearly the case for the provision of the additional UEFA content within the BT Sport channels beyond the first ten months covered by Ofcom's proposed Deferral and Recovery Periods.

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[10] Ofcom, *Fixed Access Market Reviews: Approach to the VULA margin,* 19 March 2015, paragraphs 7.146-8.
[11] Ofcom, *ibid*, paragraph 7.150.
[12] Ofcom, *ibid*, paragraph 7.149.

33. Naturally, BT welcomes Ofcom's recognition that the standard test must be adapted to apply differently to the revised BT Sport propositions. However, BT considers that the need for changes to the standard test within weeks of its entry into force illustrates the deficiencies of that test in failing to incorporate sufficient flexibility to reflect actual or likely market conditions. But Ofcom's proposals fall far short of adequately addressing the Commission's concerns that the risk of failing the test may constrain BT's actions in any defined Pay TV/content markets in which BT demonstrably has no SMP either upstream or downstream. As discussed further below, the additional flexibility around how margin on newly acquired customers should contribute to the observed losses on BT Sport between August 2015 and December 2015 is so narrowly and rigidly defined that it provides scant room for manoeuvre to BT should its investment in UEFA football content turn out to be of less value to customers than anticipated, or even if the pattern of recovery fluctuates significantly over the next 10 months.

34. Furthermore, the design of the Recovery Period (which does not align with the commercial practice that would be applied by an unregulated competitor) would mean that if the flexibility in the first 5 months was utilised, then BT would face additional margin requirements on newly acquired customers, over and above those required by the standard test, in each month from January to May 2016. In the event of customers valuing the content less than anticipated, or the pattern of recovery fluctuating, application of the modified test could perversely force BT to increase prices now and in the future, not only constraining BT's ability to compete effectively, but also leading to higher prices for consumers without any regulatory justification and contrary to Ofcom's objectives. This would create a vicious circle completely at odds with the stated objective underpinning the imposition of the VULA margin remedy – i.e. to address the risk of distortion to competition.

35. Furthermore, Ofcom's proposals leave unchanged the additional regulatory uncertainty for BT when considering bidding for future sport content as they are not based on a principled, sound economic analysis that includes an assessment of competitive effects or any clear criterion of when a future change will be regarded as sufficiently "material" to warrant a modification to the standard test or, if so, what modification may be made. Absent such clarification, it is highly likely that lack of regulatory certainty would distort BT's decision making in considering any future content investments.

36. In summary, therefore, we do not consider that Ofcom's response to the Commission's comments in its Final VULA Margin Statement combined with the very limited degree of flexibility that Ofcom is now proposing for August-December 2015, coupled with the potential for a more onerous version of the test from January to May 2016, suffice adequately to constitute a proportionate regulatory condition and/or to address the Commission's concerns regarding the overly static nature of the VULA margin test, particularly with respect to the recovery of BT Sport related costs.

3. Assessment of Ofcom's proposed modifications to the VULA margin test

Overall view

37. To the extent that the proposed modification confers limited additional pricing flexibility on BT in making changes to the way it supplies BT Sport propositions, that is of course welcome.

38. But Ofcom's proposal goes nowhere near far enough to address the serious potential for competitive distortions created by the standard test and recognised by the EU Commission, which will become all the more obvious when the BT Sport propositions change in August. Even if we agreed with the principles and structure underpinning the standard test (which we do not), Ofcom's proposals for the supplementary guidance are unnecessarily constrained. In the consultation, Ofcom does not explain how a failure of the amended test could be said to justify a presumption that BT would distort competition by virtue of changing its monetisation strategy. Ofcom seems to have taken an extremely cautious approach, but without considering the costs of this approach to BT and, indeed, competition and consumers.

39. Ofcom's approach is disproportionately costly to BT because the supplementary guidance places a burden on BT that no business facing normal competitive pressures pursuing a commercially rational investment strategy would face. It constrains our commercial flexibility to compete effectively in the retail market, notably in the pay TV sector in which BT demonstrably holds no position of market power and where we face a dominant competitor in Sky.

40. In this section we consider the specific proposals set out in Ofcom's consultation. We also consider Ofcom's rationale for not going further in giving BT more flexibility over how it will recover the additional costs associated with the new UEFA content, given the change in the monetisation strategy. We end this section by setting out what we would regard as an appropriate version of the test that would (a) provide BT with a greater degree of flexibility in line with the European Commission's comments; (b) minimise the extension of the test into unregulated markets; and (c) protect the interests of BT's retail competitors and all broadband consumers. **In particular, BT considers that a proportionate approach would be to allow BT increased flexibility around the monthly margin contributions that are made towards observed BT Sport losses over the whole UEFA football rights period**.

The overall structure of and rationale for Deferral and Recovery Periods

41. Ofcom proposes two distinct periods:

    - A **Deferral Period** immediately after the changes to the BT Sport propositions take effect, from August-December 2015, in which BT's compliance with the VULA margin regulation will be assessed by measuring the VULA margins excluding the incremental costs and revenues related to the provision of the 'UEFA channels' (BT Sport 2, BT Sport Europe and ESPN) for which BT Broadband customers need to pay an additional fee (with the exception of BT TV customers). Any margin "shortfalls" (i.e. shortfalls by reference to the ongoing monthly application of the standard test) resulting from including the costs and revenues of the UEFA channels would be netted off against any margins in

excess of the minimum margin requirement under standard test over the entire Deferral Period.

- A **Recovery Period** from January-May 2016 in which the baseline reverts to the standard test, but in addition requires that BT must recover any net shortfalls accumulated in the Deferral Period, on a straight line basis, i.e. a constant amount in each of the five months of the Recovery Period.

42. We first deal with the proposed structure of and rationale for the two Periods before discussing the appropriate length over which BT should be given additional flexibility over its cost recovery.

43. Overall we question whether it is necessary to construct two different periods, and disagree with the prescriptive recovery path during the Recovery Period. We discuss both proposed periods in turn below.

The Deferral Period

44. The Deferral Period allows BT to incur shortfalls relative to ongoing application of the standard test (and standard calculation of the net cost of Sport in any given month) in some or all months within the Period. Furthermore, any monthly shortfalls are netted off against any monthly margins in excess of the minimum margin requirements. By the end of the Period only any net shortfall needs to be carried forward into the proposed Recovery Period.

45. We agree in principle that having made changes to its commercial propositions and monetisation approach, that BT should not be required to make margin contributions on new SFBB customers that cover that standard net cost of BT Sport calculation from month one. But we do not agree that this flexibility should be limited to such a short time period. We expand on this further below.

The Recovery Period

46. In the Recovery Period, BT is required to not only revert to passing the standard test in each month, but also to make further additional margin to cover any net margin shortfalls accumulated during the Deferral Period. It must recover any shortfall in a prescriptive straight line fashion – i.e. a defined equal contribution (after discounting) must be made on margin in each month, not simply in aggregate across the Recovery Period.

47. We fundamentally disagree with the design of and rationale for the Recovery Period.

48. First, it is unclear why, if Ofcom's fundamental concern is with BT making sufficient margin from new SFBB customers to recover the additional net costs of Sport arising from the supply of UEFA content (largely driven by the significant fixed costs of rights for the full three seasons), its approach would ignore any net 'surplus' earned (i.e. above the margin required to make the defined monthly contribution to the net cost measured in that month) whether on an aggregate basis within the Deferral Period or in any subsequent month for which the UEFA rights were supplied. Ofcom's approach is that the monthly margin earned on each monthly cohort must contribute a defined amount to recover the costs of supplying BT Sport based on that month's observed losses. If BT ended the Deferral Period with an overall net surplus, BT would, under Ofcom's proposals, simply have to revert to earning monthly margin to pass the standard test. If BT earned further surplus in subsequent months, the standard test would still need to be earned in all future months.

49. But if certain monthly cohorts contribute additional 'surplus' margin based on Ofcom's measure of net costs, then it is unclear why other cohorts could not make lower contributions towards those fixed costs. In particular, it is not clear why any such monthly 'failure' could be considered distortive if overall margin over time was seen to be sufficient to recover the fixed rights costs.

50. Second, Ofcom has not explained why failing the modified test in any month of the proposed Recovery Period would be indicative of BT distorting competition in those months.

51. For illustration consider the following simplified numerical example (ignoring the NPV calculation). We assume a Deferral Period net shortfall of £5m. VULA margins including the standard net cost of Sport but before recovery of any shortfall from the Deferral Period are positive but are assumed to vary in line with the UEFA football calendar as volatility in revenues impacts the standard monthly net cost of sport calculation:

In £k	Jan	Feb	Mar	Apr	May	Total
Margin before Recovery	800	800	1,300	1,400	900	5,200
Recovery	-1,000	-1,000	-1,000	-1,000	-1,000	-5,000
Net margin	-200	-200	300	400	-100	200

52. Because of the break in the UEFA competitions in January/February and again in the latter half of May it would not be unrealistic to assume comparatively lower revenues from BT Sport in these months. In this example, the margin across the Recovery Period would be sufficient to recover the £5m shortfall in the Deferral Period. But BT would still fail the proposed modified Recovery Period test in 3 of the 5 months. To avoid this, BT would have to increase its prices for SFBB offers (or for BT Sport) in January and February 2016, when no UCL matches are played – the very months in which the UEFA content would be of less value to customers.[13] Ofcom has not explored the implications of such counterintuitive results from its tests and why such price changes would be necessary to prevent a distortion of competition for superfast broadband products.

53. Furthermore, by virtue of the mechanics of Ofcom's calculation of the net costs of Sport, the extra £1m monthly Recovery costs would be allocated over a still growing SFBB customer base. This means that the unit impact of the additional costs would be decreasing over time – meaning that the margin impact on a per customer basis would be highest in January and lowest in May. Ofcom does not explain why this would be a rational cost recovery path that is necessary to achieve its regulatory objective. Rather, it is the opposite of a commercially rational cost recovery path, which would be to load more cost recovery into later months to match increasing take up.

[13] We note that this perverse effect not only applies in the specific circumstances of the BT Sport Pack but also more widely where Ofcom ignores seasonality effects in the net costs of Sport driven by the sporting calendar. At the least, such considerations would indicate that cost recovery (for an annual competition such as the UCL and UEL competitions) should be viewed annually, allowing for such fluctuations over the sporting year.

Length of Deferral and Recovery Periods

54. Ofcom proposes that both the Deferral and Recovery Periods should be no longer than five months each. We consider that this is significantly too short both individually and in totality, and we disagree with Ofcom's rationales in support of their proposals.

The Deferral Period

55. Ofcom defends the length of the Deferral Period by reference to BT's own volume and revenue forecasts, the structure of the UEFA football competitions and the performance of other sports pay TV channels (although Ofcom placed less weight on the last point since other pay TV channels were not directly comparable to the BT Sport Pack). We discuss the implications of these three sources of evidence in turn below.

<u>BT's volume and revenue forecasts</u>

56. The graph below compares the volume and revenue forecast trends (based on forecasts submitted to Ofcom in May 2015):

    [✂]

57. Ofcom argues that the Deferral Period matched a period with sharp expected growth that would have reached [✂] of the peak in volumes in the first year. [✂] but dismisses this as irrelevant as their focus was *"on the short run issues associated with the launch of the UEFA Channels".* More generally, any extension of the Deferral Period was ruled out with reference to Ofcom's overriding concern that any additional flexibility over BT's cost recovery path would risk undermining the effectiveness of the VULA margin regulation.[14]

58. First, we believe that Ofcom has misunderstood or misstated the economic rationale underlying the need to make changes to the standard VULA margin test in light of the material change of circumstances from August 2015. The factors justifying amendment of the test are not "short run" issues associated only with the "launch" of the UEFA Channels. Rather, the need for a different approach results from the inflexibility in the standard test which is unable to accommodate the significant change in the way in which BT offers its BT Sport products. Whereas before August 2015, a much more significant part of its BT Sport channels was offered to BT's broadband customers free of charge, most BT broadband customers will in future have to pay for the BT Sport Pack, including the UEFA football competitions. This is not an issue that is limited to the launch period but pervades the entire period over which the new content is offered.

59. Second, while Ofcom's approach might come closer to being coherent from a pure cost recovery perspective (as opposed to actual effects on competition) if it were trying to pinpoint a particular moment in time at which costs and revenues could be expected to reach a more mature steady state, that moment [✂]. In particular, the revenue forecast curve shows that [✂], when it reaches [✂] of the peak monthly revenues during the three seasons for which the UEFA rights are held. On this basis alone a Deferral Period lasting over the entire first and second seasons (24 months) would be a more reasonable proposition than the proposed 5 months.

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[14] Ofcom, *Supplementary guidance on assessment of the VULA margin*, 11 June 2015, paragraph 2.19, 4th bullet.

60. Volume increases are an essential element of being able to grow revenues. However, [✂] and consequently will not reflect a steady state. Indeed, Ofcom has itself acknowledged [✂].[15]

The UEFA competition schedule

61. The revenue forecast curve also shows very clearly the impact of [✂], driven by the UEFA competition schedule. It would suggest that the minimum margin requirement would [✂]. A Deferral Period shorter than one year is unable to address [✂]. Ofcom does not recognise these in its proposed supplementary guidance and appears to argue that these are outside of what it would regard as relevant material changes of circumstances. There is clearly no basis for such a conclusion.

62. Further, Ofcom argues that the end of the first phase of the first Champions League season by December supports the proposed end of the Deferral Period in the same month. This fails to recognise, however, that [✂]. The effect of the proposals is that BT will be expected to recover any shortfalls on a rigid monthly basis [✂] for reasons that have nothing to do with competition in the supply of SFBB bundles and therefore nothing to do with Ofcom's regulatory objectives but simply reflect the structure of the UCL competitions.

Other pay TV sports channels

63. Ofcom refers to [✂] the take-up of previous sports channels (namely, Setanta, ESPN and BT Sport) on Sky's pay TV platform in support of a five-month Deferral Period. Ofcom itself acknowledges that these data are less useful as these channels had very different propositions based around Premier League football (where the matches are played throughout the 9-month period August-May). Furthermore, ESPN and Setanta were stand-alone pay TV channels, therefore their monetisation model was different from that of BT Sport. But even if a comparison with the previous channels were relevant, it is notable that [✂].

    [✂]

64. Furthermore, as we have shown above, volume growth on its own only reveals one part of future revenue trends, as prices also increase over time. Indeed, BT increased prices for BT Sport channel only customers and started charging BT Broadband customers for HD in the second season. This is reflected in the graph below which shows that [✂].[16]

    [✂]

65. The data from other pay TV channels is therefore not supportive of a short five-month Deferral Period.

66. We note that in paragraph 2.22, Ofcom recognises that [✂]. It suggests that [✂], and therefore Ofcom's argument on this point is without basis.

The Recovery Period

67. Ofcom relies on two arguments to support their proposal of a five month recovery period, lasting from January until May 2016.

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[15] Ofcom, *ibid*, paragraph 2.22 and footnote 25.

[16] Note that we only have data for two seasons, so this should not be read as suggesting that [✂]. It may well be the case that [✂].

- First, Ofcom argues that both forecast volumes and revenues for the first year peak around [✂].
- Second, the Champions and Europa League seasons finish in May and only start again in August.

68. As both factors align with May, Ofcom argues these two factors support their proposal. But Ofcom specifically states that the decision *"involves the exercise of judgement"*.[17] The choice of a very short Recovery Period is mainly founded in Ofcom's concern that by allowing BT to recover early losses from these future revenue increases it may enable *"the behaviour that our VULA margin regulation is seeking to prevent."*[18]

69. Ofcom therefore completely ignores forecasts of [✂]. We discussed above why ignoring these forecasts leads to a flawed and unduly short Deferral Period, and the same considerations equally apply to the Recovery Period.

70. Ofcom does not explain why aligning the end of the Recovery Period with the end of the first UEFA season provides any benefits. As discussed, in order to smooth out the seasonalities in the football seasons, the Deferral Period cannot be any shorter than one entire season. At a minimum, and assuming that the Deferral Period is set at only one season, the Recovery Period should then allow BT to recover any shortfalls from the first season from future projected revenues in the second and third seasons.

71. We explain in the next section why we disagree with Ofcom's view that more flexibility for cost recovery for the new UEFA channel propositions would provide an opportunity to BT to distort competition.

Alternative approaches to defining the appropriate level of additional flexibility

72. Ofcom's modified approach would still focus on the observed unrecovered losses of the BT Sport business, notwithstanding that currently BT is still very much a new entrant. This remains a fundamental concern despite the proposal to introduce some flexibility in how those losses are recovered from the margin on each monthly cohort of new SFBB customers. But, putting that fundamental concern to one side in this response, even if Ofcom's focus is on ensuring BT's margin on SFBB customers recovers short term losses, the proposed treatment of the additional costs of the UEFA content – dominated by the rights costs – is far too restrictive:

    - Seasonality effects mean that [✂]. This alone suggests there should be a minimum length of at least one entire season in which BT may be allowed monthly margin shortfalls against the standard test.
    - [✂] suggests that any flexibility period shorter than two seasons would seriously constrain BT's ability to [✂]. This is especially true in the face of aggressive competition from Sky who has, over the last year, been trying to pre-empt its customers switching to BT when the changes to the BT Sport offers take effect[19] and as recently as last week launched offers including free fibre broadband.[20]

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[17] Ofcom, *ibid*, paragraph 2.20.
[18] Ofcom, *ibid*, paragraph 2.22.
[19] Enders Analysis, BT Sport – the Champions?, published 30 June 2015, page 5: [✂]
[20] *"One year free superfast Sky fibre"*, http://www.sky.com/#!sky-fibre-july2015, accessed on 10 July 2015.

73. Taking these factors into account, the most economically rational proposal to address Ofcom's focus on short term cost recovery of the additional UEFA rights costs would be to allow for a single Recovery Period that matches the duration of the rights period (August 2015-May 2018). That is, by Ofcom's own logic, that only the margin BT earns across the rights period should be sufficient to cover the additional costs. BT would then have full flexibility to recover those costs in ways which would be reflective of the minimum constraints any of BT's competitors would face when considering whether they wanted to make the same investment as BT.

74. We nevertheless recognise that Ofcom may want to assure itself between now and the end of the current market review period in 2017 that BT's cost recovery path for the new content gives no rise for concern and is not suggestive of BT using any flexibility to undermine the VULA margin regulation. Whilst any relaxation is clearly preferable to the current disproportionately restrictive standard test, the flexibility that Ofcom proposes falls well short of what is required to avoid the risk of competitive distortions against BT which that standard test creates (i.e. the risk which the Commission identified and of which it specifically warned Ofcom). Ofcom's rationale for keeping the structure and length of the additional flexibility periods so narrow is arbitrary and unjustifiably prescriptive where a number of alternative, more reasonable approaches could easily be envisaged. In choosing to provide for flexibility on unnecessarily tightly controlled terms, Ofcom is perpetuating rather than resolving the underlying problems of the standard test.

75. In its consultation, Ofcom has not considered any alternative approaches to the one proposed. However, there are a number of obvious alternatives that would be possible and that Ofcom should consider. Considering alternative approaches is important to establish that costs and regulatory burdens resulting from Ofcom's regulation have been kept to the minimum necessary. This is in accordance with Ofcom's duty to impose the least burdensome regulation available that allows it to meet its regulatory objective.

76. For the avoidance of doubt, as argued above we believe that the most proportionate approach is to allow BT to spread the recovery of additional costs for the UEFA football content flexibly over the duration of the rights period – i.e. until the end of the 2017/18 season. However, even if the concern was about the phasing of cost recovery across the period, Ofcom could retain the proposed distinction of a Deferral and a Recovery Period, but with a more appropriate structure reflecting market realities.

77. We would suggest that the Deferral Period could be no shorter than 12 months, taking account of seasonality effects in an annual competition. We disagree with Ofcom's concern that a Recovery Period longer than 5 months may provide BT with too much flexibility to set too low prices during the Deferral Period and have the potential to distort competition and no evidence has been presented to explain what competitive distortions would actually arise. Indeed, Ofcom's focus on cost recovery during the rights period suggests that any Recovery Period required could then cover the remainder of the rights period. That is, if Ofcom accepted a 12 month Deferral Period, the Recovery Period could be set for 24 months. Ofcom could also then allow greater flexibility in how any net shortfall at the end of any Deferral Period was recovered from the margin earned in each month of the Recovery Period.

78. **In summary, we believe that full cost recovery flexibility over the entire UEFA football rights period would be the most reasonable approach and would be in line with Ofcom's regulatory objective A Deferral Period of one year, followed by a two-year flexible Recovery Period, represents the minimum flexibility required to**

avoid the risk of competitive distortions which would otherwise result – any more stringent restriction would represent a disproportionate restriction that failed to reflect the least restrictive regulatory alternative compatible with Ofcom's regulatory objectives.

4. Future material changes in circumstances

79. BT is also concerned about the general approach adopted in the consultation document and the extent to which Ofcom may intend to establish a regulatory precedent for other possible future changes. As Ofcom is aware, Ground 3 of BT's appeal is based on the contention that the approach that Ofcom has adopted is contrary to the EU general principle of legal certainty in failing to specify either the circumstances in which a material change will be found to have arisen or, if that is the case, how Ofcom will address that change.

80. It appears that Ofcom's intention is to consider each future material change in circumstances on its own terms and how to depart from its original test on a case-by-case basis. This gives rise to significant and unnecessary regulatory uncertainty for BT. We believe that Ofcom could use this consultation to establish a clearer framework for how it would approach other changes in circumstances leading to further modifications of the test s.

81. The following two areas appear to be of particular relevance:

    a. How Ofcom would assess patterns of growing demand over time, high fixed costs and declining unit costs over time. The present supplementary guidance suggests that Ofcom would recognise these but only in very limited circumstances that fall short of what would otherwise be a commercially rational cost recovery pattern for a significantly changed or newly launched product which would raise no concerns in a normally competitive market.

    b. The extent to which Ofcom recognises and makes allowances for commercial risk-taking and potentially perverse outcomes from applying its VULA margin test in changing circumstances. The present supplementary guidance suggests that Ofcom will not recognise these issues and is happy to accept potentially counterintuitive outcomes that would exacerbate the normal commercial risks involved in investing in innovation of its existing products and launching new products. In short, the regulation adds a layer of significant regulatory risks in case of commercial failure. We discuss these issues further below.

Product changes involving commercial risks

82. Whenever BT changes its propositions or launches new products that it intends to bundle with its broadband products the VULA margin test can lead to some highly counterintuitive outcomes that could be characterised as a competitive paradox. We use the changes to the BT Sport propositions as an example to illustrate this paradox:

    a. The costs that relate to the additional UEFA content are largely fixed and sunk. Therefore the level of monthly net costs is variable mainly in the volume of customers who subscribe to the channel and any add-ons such as HD, and the price they are willing to pay for it.

    b. Should only a few customers be interested in the new propositions at the prices at which they are offered, BT would generate little revenue against its fixed costs. Equally, BT could in theory fail the test because it fails its sales targets for the BT Sport Pack to pubs and clubs, generating lower than anticipated revenues. Consequently the monthly net cost of Sport which BT needs to recover from its

superfast broadband margins to retail customers increases with decreasing demand from pubs and clubs.

c. Likewise, should BT have to lower its prices for the BT Sport Pack to generate more demand, the monthly net cost of Sport would push up the monthly margin requirement on superfast broadband bundles.

d. Yet in both cases the reason for the increasing net costs of Sport is a lack of interest from customers, which means the provision of BT Sport is unlikely to affect their choice of broadband provider. In other words, there can be no suggestion in those circumstances of a risk that BT may use BT Sport to distort competition for superfast broadband products. Therefore the outcome of the VULA margin test would bear no relationship to its regulatory objective and would likely create competitive distortions in unregulated markets instead.

e. Further, because BT would in that event be required to recover higher margins from its superfast broadband products to make up for the lack of interest in BT Sport, it may be forced to increase its bundled prices to a level that would not allow it to compete effectively in the broadband market. In other words, it would start to lose customers to its competitors, thereby further increasing the per subscriber margins it would need to achieve, in order to recover its largely fixed cost base. This downward spiral would exacerbate even further the competitive paradox as the less effect the new product has on competition, the higher its effect on the VULA margin requirement.

83. Any significant change to the products offered to customers carries some unavoidable commercial risks that it may not be as successful as initially expected. While BT has clearly not designed the proposed changes to the BT Sport offerings and the addition of the UEFA football content to be unsuccessful, it is clearly a high profile initiative with significant commercial risks. The fact that Ofcom does not consider such a risk shows a significant conceptual oversight in Ofcom's approach – it does not provide for the possibility of a commercial failure, which is a normal feature of any normally competitive market. Ofcom has to date refused to give a view on this paradox, and has not given any indication that it would vary its approach any further than in the narrow circumstances considered in, and to the limited extent proposed by, this consultation. This means that not only does BT face the normal risk of a commercial failure, but its risk is also exacerbated through the VULA margin requirements that force BT to recover in the broadband market any losses that may arise from a commercial failure in a new product market on which it lacks market power. This is a regulatory concern that is raised by the Commission but that Ofcom has failed to address either in the Final Statement or in the present consultation.

84. To provide regulatory certainty and to avoid regulation which has the perverse consequence of increasing commercial risks, we invite Ofcom to give additional guidance on how it would deal with this competitive paradox in its application of the standard test to changing commercial circumstances.

5. Notification to the European Commission

85. This consultation appears to reflect Ofcom's response to the comments of the European Commission. If implemented, Ofcom's proposal will result in amendments to the nature of the restriction on BT's commercial freedom imposed by the test in relation to a major commercial initiative that was clearly anticipated by Ofcom when the original condition was imposed.

86. In substance, the very specific statement of what BT will have to do to be compliant with the condition if the proposal in the consultation is implemented amounts, at the very least, to a measure which amends the obligation on BT for the purposes of the Article 7 Framework Directive procedure. Alternatively, if it is not an amendment of the existing obligation, it is the imposition of a new form of SMP obligation on BT for the period from August 2015 to May 2016, a period of ten months out of the total period of 24 months (i.e. from March 2015 to the conclusion of the next Fixed Access Market Review by March 2017) that the standard test will be in force. Whilst it may allow BT a degree of flexibility of costs recovery between August and December 2015, as explained above, the Recovery Period, between January and May 2016, is potentially even more onerous and rigid in its operation than the SMP obligation currently in force.

87. We therefore consider that Ofcom's decision will require notification to the European Commission pursuant to the Article 7 Framework Directive notification procedure and we invite Ofcom to confirm that it will notify its finalised proposals to the Commission prior to adopting its decision.

88. Finally, in this regard, we would refer to Case C-3/14 - Prezes Urzędu Komunikacji Elektronicznej and Telefonia Dialog sp. z o.o. v T-Mobile Polska SA, judgment of 16 April 2015, which BT contends is support for the proposition that implementation of the Article 7(3) procedure is contingent on the actual subject-matter of that measure (and the effect that it may have on trade between member states) rather than the nature of the procedure in the context of which the NRA intends to take the measure. Accordingly, the fact that Ofcom is seeking to alter the way in which the SMP obligation applies to BT by amending the Guidance on the application of the condition does not exclude the statutory requirement for an Article 7 notification.

Annex 1 - BT's changed BT Sport propositions

89. On 9 June 2015, BT announced the introduction of a new BT Sport pack, which will comprise BT Sport 1, BT Sport 2, ESPN on BT Sport and the new BT Sport Europe channel. BT Sport Europe, which will launch on 1 August 2015, will broadcast UEFA Champions League and Europa League content. New and existing BT Broadband customers will be charged £5 per month for the BT Sport Pack, which will be accessible via their satellite service or via the BT Sport App. All BT Sport channels will be available in standard definition and in HD for an extra £4 a month. The BT Sport pack will only be free for customers who subscribe to BT TV.

90. Ofcom's intention to consider BT's launch of the UEFA channels as a material change of circumstances, is justified because:

    - There has been a change in BT's monetisation strategy, with BT Broadband customers now required to pay to access the new content. As noted above, free access to all BT Sport channels is only available to those who subscribe to BT TV.
    - The sheer scale of BT's rights costs, which total £900 million, are fixed. When these costs apply in August, and then fully in September, they will have the effect [✂]. It is unreasonable to expect those increases in costs to be offset by immediate increases in revenue.