Supplementary guidance on assessment of the VULA margin

Redacted version ✂

Statement

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About this document

This is a statement on supplementary guidance on the minimum margin that British Telecommunications plc ('BT') must maintain between its wholesale and retail superfast broadband prices.

On 19 March 2015, we published a statement setting out detailed requirements on the minimum margin and guidance on how we would assess compliance with those obligations. That guidance anticipates that there might be material changes in circumstances which would warrant a departure from that guidance.

In June 2015, BT announced changes to its BT Sport retail proposition. These changes are linked to BT beginning to broadcast UEFA football from August 2015. We consider that these changes constitute a material change of circumstances and so, having consulted on our approach, we now set out supplementary guidance regarding how we would undertake our assessment of the minimum margin during the launch period of this new proposition.

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Section 1

Introduction

Background

1.1 On 19 March 2015 we published a statement setting out our approach to regulating the VULA[1] margin ('the VULA Margin Statement').[2] In that statement we imposed a condition requiring BT to maintain a minimum VULA margin. We also published guidance on how we intend to undertake our assessment of compliance with that condition. That guidance anticipates that there might be material changes in circumstances which would warrant a departure from that guidance.

1.2 BT wrote to us on 2 April 2015 asking whether planned changes to its BT Sport retail proposition involving UEFA football would constitute a material change of circumstances and, if so, how we would undertake our assessment of compliance with the VULA margin condition following that change.

1.3 Having considered the information provided to us by BT, we decided that this change would constitute a material change of circumstances and that it would be appropriate to consult on supplementary guidance.

1.4 BT subsequently provided us with some further information regarding its planned changes in response to a statutory information request. On 9 June 2015, BT announced its plans.[3]

1.5 In light of these developments, we published on 11 June 2015 a consultation on supplementary guidance regarding how we would undertake our assessment of the VULA margin condition during the launch period of BT's new proposition ('the June 2015 VULA Consultation').[4]

1.6 Taking account of responses[5] to that consultation, in Section 2 we now set out our final guidance on this matter.[6] Overall the structure of our approach is the same as in

[1] Virtual Unbundled Local Access ('VULA') provides access to BT's Next Generation Access ('NGA') network. The VULA margin is the differential between the price of the wholesale VULA input offered by British Telecommunications plc's ('BT') access division (Openreach) and the price of those retail packages offered by BT's retail divisions that use VULA as an input.

[2] Ofcom, *Fixed Access Market Reviews: Approach to the VULA margin*, 19 March 2015, http://stakeholders.ofcom.org.uk/consultations/VULA-margin/statement

[3] BT, *UEFA Champions League and UEFA Europa League to be free with BT TV*, 9 June 2015, http://www.btplc.com/News/#/pressreleases/uefa-champions-league-and-uefa-europa-league-to-be-free-with-bt-tv-1175981

[4] Ofcom, *Supplementary guidance on assessment of the VULA margin – consultation*, 11 June 2015, http://stakeholders.ofcom.org.uk/binaries/consultations/vula-margin-guidance-supplementary/summary/VULA_margin-guidance-supplementary.pdf

[5] We received responses from BT, Sky, TalkTalk and a member of the public. The responses can be found on our website: http://stakeholders.ofcom.org.uk/consultations/vula-margin-guidance-supplementary/?showResponses=true. The member of the public suggested that Ofcom should consider whether "*its findings on BT's charges … should also apply to users of Plusnet*". Whilst this suggestion does not appear to relate to the subject matter of the consultation, we note that the VULA margin condition (SMP Condition 14) does take into account BT's costs and revenues from Plusnet. In particular, the definition of "*Retail Divisions*" in the VULA margin condition includes Plusnet.

the June 2015 VULA Consultation and identifies separate Deferral, Recovery and Final Periods (these terms are defined below). However, we conclude that the length of these periods should be changed. We consulted on the proposal that the Deferral and Recovery Periods should both be five months. Our conclusion is that the Deferral Period should be twelve months and the Recovery Period should be nine months.

[6] BT suggested that Ofcom's decision on any supplementary guidance would require notification to the European Commission pursuant to Article 7 of the Framework Directive (2002/21/EC) (paragraphs 18, 85, 88, BT response to the June 2015 VULA Consultation). We do not consider that notification is required since the supplementary guidance set out in this statement does not itself constitute a measure which falls within the scope of Articles 15 or 16 of the Framework Directive or Articles 5 or 8 of the Access Directive (2002/19/EC).

Section 2

Supplementary guidance

Introduction

2.1 This section is structured as follows:

- our understanding of BT's plans;
- launch of the UEFA Channels – issue and approach;
- the length of the Deferral and Recovery Periods;
- further details on the calculation and recovery of any shortfall accumulated during the Deferral Period; and
- BT's request for further guidance on other matters.

Our understanding of BT's plans

2.2 Our approach reflects our understanding of BT's plans.[7]

2.3 BT intends to continue offering a 'free' sports channel (BT Sport 1) to its broadband subscribers.[8] In addition, from August 2015 it has offered a suite of sports channels (the "*BT Sport Pack*", consisting of BT Sport 1, BT Sport 2, BT Sport Europe and ESPN).[9] BT broadband subscribers have to pay £5/month to receive the BT Sport Pack, although customers that re-contract both BT broadband and BT TV for 12 months receive these channels for 'free'. Customers on Sky's pay TV platform that do not subscribe to BT broadband have to pay £19.99/month to receive the BT Sport Pack in standard definition ('SD'). [✂].[10] In general, new BT customers will need to subscribe to BT broadband and the BT Sport Pack for at least 12 months. For existing BT Sport customers, in general the minimum term will be 30 days.[11]

2.4 The BT Sport channels are available to Virgin Media customers. [✂].

[7] Our understanding reflects BT's 9 June 2015 press release announcing its proposals as well as BT's response to a series of information requests. BT response to questions 2-5 of the s.135 notice of 23 April 2015; and BT response to questions 3-6 of the s.135 notice of 12 May 2015. BT, *UEFA Champions League and UEFA Europa League to be free with BT TV*, 9 June 2015, http://www.btplc.com/News/#/pressreleases/uefa-champions-league-and-uefa-europa-league-to-be-free-with-bt-tv-1175981

[8] This channel focuses on Aviva Premiership Rugby, Scottish Premier League football and FA Premier League football.

[9] The content that will be shown on these additional channels is still being developed. It includes UEFA Champions League football, UEFA Europa League football, European Rugby Champions Cup, the FA Cup, Moto and UFC.

[10] BT response to question 2 of the s.135 notice of 12 May 2015; and BT response to question 2 of the s.135 notice of 22 July 2015.

[11] New BT Sport subscribers on Sky's pay TV platform that do not subscribe to BT broadband can choose either a 12 month minimum term with a £15 activation fee or a 30 day minimum term with a £30 activation fee [✂].

2.5 BT will also broadcast some content, including UEFA football, on a new free to air channel (BT Sport Showcase).[12]

Launch of the UEFA Channels – issue and approach

2.6 In this statement, 'the UEFA Channels' correspond to BT Sport 2, BT Sport Europe and ESPN. These are the additional channels in the BT Sport Pack over and above the 'free' sports content that BT broadband subscribers receive (namely BT Sport 1). In order to receive these channels, BT broadband customers (apart from those also taking BT TV) must pay an additional fee. We consider that the launch of the UEFA Channels represents a material change in circumstances.

2.7 Below we first discuss the nature of the issue we are seeking to address (i.e. why the material change in circumstances means a departure from the guidance set out in the VULA Margin Statement is warranted). Having identified that issue we then discuss the appropriate approach for addressing it.

The issue we are seeking to address

Position in the June 2015 VULA Consultation

2.8 In the June 2015 VULA Consultation we stated that mechanically applying the approach set out in the VULA Margin Statement can lead to problems following the launch of the UEFA Channels (which BT broadband subscribers must pay for), when take-up of these channels may be atypically low.[13]

Stakeholder responses

BT

2.9 BT considered that we had misunderstood the rationale for making changes to the VULA margin assessment. It stated that:

> "The factors justifying amendment of the test are not "short run" issues associated with only the "launch" of the UEFA Channels. Rather, the need for a different approach results from the inflexibility of the standard test which is unable to accommodate the significant change in the way in which BT offers its BT Sport channels … most BT broadband customers will in the future have to pay for the BT Sport Pack … This is not an issue that is limited to the launch period but pervades the entire period over which the new content is offered."[14]

2.10 BT criticised the approach and reasoning set out in the VULA Margin Statement.[15] BT considered that our proposals in the June 2015 VULA Consultation do not address BT's concerns with the approach set out in the VULA Margin Statement.[16]

[12] This will include at least 12 Champions League matches and 14 Europa League matches. Each participating British team will be shown at least once.
[13] We did so by reference to paragraphs 6.23-6.24 of the VULA Margin Statement.
[14] Paragraphs 58, BT response to the June 2015 VULA Consultation.
[15] Paragraphs 3-4, 19-23, 28-29, 36 and footnote 13 to paragraph 52, BT response to the June 2015 VULA Consultation.
[16] Paragraphs 16, 38, BT response to the June 2015 VULA Consultation.

BT also considered that our proposals are insufficient to address the European Commission's comments on the draft VULA Margin Statement.[17]

2.11 BT disagreed with our proposed approach and set out its preferred alternative.[18] BT's alternative approach is set out in further detail in paragraphs 2.24-2.26 below.

Other stakeholders

2.12 TalkTalk agreed with our proposals. It considered that it is appropriate to allow BT to defer recovery of some of the costs of the rights to UEFA football while it builds its base of paying subscribers. However, it considered that we should continue to review whether our approach remains appropriate in light of market developments.[19]

2.13 Sky did not comment on Ofcom's proposed approach to the timing of the recovery of the costs of BT Sport. Rather, Sky considered that the use of the net costs of BT Sport in the VULA margin assessment was inappropriate given the August 2015 changes to BT's pricing. Sky considered that a net costs approach does not address the issues around consumers 'self assembling' a bundle by taking superfast broadband from another provider and purchasing BT Sport on a standalone basis. Sky was concerned that BT could discourage 'self assembly' by setting a high standalone price for BT Sport. The standalone monthly subscription price of the BT Sport Pack in SD on Sky's TV platform has increased to £19.99. Sky considered that even if a rival broadband provider were to substantially undercut BT's broadband price, it is unlikely to be able to compete for broadband subscribers that also value BT Sport.[20] Accordingly Sky considered that we should use the standalone prices charged by BT.[21]

The issue we are seeking to address

Ofcom's view on the issue created by the material change in circumstances

2.14 BT and Sky's comments dispute the nature of the issue that we were seeking to address in the June 2015 VULA Consultation. Our view on that issue is as follows.

2.15 In the VULA Margin Statement we set out an illustrative example:

> "… assume that BT adds an extra feature or product to its superfast broadband bundles and that it charges consumers taking this product/feature. On the first month that the feature/product is added, it will result in a number of extra costs for BT. However, during that first month the volumes associated with that extra feature/product may still be very low. As a result, were the VULA margin assessment conducted using data relating to the first month only, then BT's estimated margin may be too low. In contrast, BT's margin may be

[17] Paragraphs 6-8, 26-27, 33, 36, and 74, BT response to the June 2015 VULA Consultation.
[18] BT argued that the available evidence suggests it would be more reasonable and proportionate for BT to have flexibility over a much longer period (Paragraph 11, BT response to the June 2015 VULA Consultation).
[19] TalkTalk response to the June 2015 VULA Consultation.
[20] A consumer that is interested in the BT Sport Pack pays £5/month extra with BT broadband or £19.99/month for a subscription on Sky's pay TV platform if they take third party broadband. A consumer that just values BT Sport 1 receives this channel for 'free' with BT broadband but pays the full £19.99/month if they take third party broadband and obtain this channel as part of the BT Sport Pack.
[21] Paragraphs 5-9, Sky response to the June 2015 VULA Consultation.

> sufficient when compliance is assessed in further months, once the volumes associated with that extra feature or product have increased."[22]

2.16 While we were mindful that future price rises or growth in BT's superfast broadband subscribers may reflect the exclusion of competitors, we recognised that under the circumstances where it is appropriate to place more weight on BT's ability to build scale, it may be appropriate to depart from the guidance set out in the VULA Margin Statement.[23]

2.17 As the above quote makes clear, under the approach set out in the VULA Margin Statement issues can arise in the period after the launch of the UEFA Channels, when take-up may be atypically low.[24] We consider that it is appropriate to depart from the guidance set out in the VULA Margin Statement in order to reflect the special circumstances that may arise in the period after launch of the UEFA Channels.

2.18 However, we do not consider that it is appropriate to depart from the guidance set out in the VULA Margin Statement for the entirety of the period that BT is growing its UEFA subscriber base. Indeed that guidance was developed to reflect an environment in which BT may experience some growth.[25] That guidance also takes into account the risk that adjusting the profile of cost recovery can undermine the effectiveness of our VULA margin regulation.[26] Rather, we have decided to depart from the guidance in the VULA Margin Statement for the initial phase after the launch of the UEFA Channels when take-up may be atypically low. Once that phase is over, and even if BT is expected to still experience some further growth, we will revert to the approach set out in the VULA Margin Statement.

The wider issues raised by BT

2.19 As noted above, BT's response raised a broader set of concerns about the approach set out in the VULA Margin Statement. Since these broader concerns fall outside the specific issues created by the material change in circumstances that we have identified, they are not considered further in this statement.

The 'self assembly' issue raised by Sky

2.20 Sky's proposal that we should use the standalone price of BT Sport in the VULA margin assessment reflects Sky's concerns about 'self-assembly'. This differs from our concern about the special circumstances that may arise in the period after the launch of the UEFA Channels.

2.21 Sky has previously made similar arguments. In the VULA Margin Statement, we recognised that there would be merit in Sky's approach if BT were found to have

[22] Paragraph 6.23 (footnote omitted), VULA Margin Statement,
[23] Paragraphs 6.24-6.25, VULA Margin Statement.
[24] Costs may be atypically high during the launch period. However we are likely to smooth these launch costs over a five year period (paragraphs 6.305-6.306 and 6.385-6.388, VULA Margin Statement).
[25] See for example the discussion of rising direct revenues at paragraphs 6.307-6.312, VULA Margin Statement.
[26] Paragraphs 6.291-6.302 and (particularly) 6.292B-6.295, VULA Margin Statement.

SMP in the provision of premium sport channels.[27] However, we said that we did not believe that this was the case.[28] This continues to be our view.[29]

Approach for addressing take-up of the UEFA Channels after their launch

2.22 We now discuss our approach for addressing the issue arising from the launch of the UEFA channels identified in paragraphs 2.14-2.18.

Proposed approach in the June 2015 VULA Consultation

2.23 We proposed identifying three distinct periods after the launch of the UEFA Channels: the Deferral Period, followed by the Recovery Period and then the Final Period. We proposed adopting a different approach to assessing BT's VULA margin in each of these three periods.

- The Deferral Period: During the Deferral Period, compliance should be assessed using the approach set out in the VULA Margin Statement (including the existing guidance) subject to one difference – when carrying out this assessment the incremental costs and revenues associated with the UEFA Channels are excluded. These are the extra costs associated with supplying these channels (over and above the other BT Sport content that is supplied to BT broadband subscribers for 'free') and the extra revenues from supplying those channels.[30]

- The Recovery Period: At the end of the Deferral Period, we would calculate whether there has been a shortfall relative to the approach set out in the VULA Margin Statement and existing guidance. If so, the shortfall would need to be recovered during the subsequent Recovery Period. During the Recovery Period the VULA margin in each compliance period must be sufficient to recover BT's costs, calculated in accordance with our existing guidance and including the costs and revenues of the UEFA Channels. In addition, over this period the VULA margin must be sufficient to recoup any shortfall that occurred during the Deferral Period.

- The Final Period: After the Recovery Period, the VULA margin in each compliance period must be sufficient to recover BT's costs, calculated in the

[27] This is because if, for example, BT Sport were 'must have' content for broadband subscribers then selecting a third party broadband provider would effectively require 'self assembly' of a bundle that also contains BT Sport.
[28] Paragraphs 6.265-6.266, VULA Margin Statement.
[29] This is consistent with our provisional conclusions in the review of the wholesale must offer obligation in relation to Sky Sports 1 and 2 (although these relate to the preferences of pay TV subscribers rather than broadband subscribers). We stated that BT has been growing its portfolio of key sports rights. Nevertheless, survey evidence suggests that the content available on BT Sport influences only a small proportion of consumers' choice of pay TV retailer. In addition, BT's share of revenues in the supply of key sports channels is modest and it has a relatively small retail TV subscriber base. Limited distribution of BT's content may therefore result in a small impact on short-term competition. However this may be offset if BT establishes itself as a more effective competitor. See paragraph 1.17, Ofcom, *Review of the pay TV wholesale must-offer obligation*, 19 December 2014, http://stakeholders.ofcom.org.uk/binaries/consultations/wholesale-must-offer/summary/condoc.pdf
[30] Calculating the incremental revenues for the UEFA Channels from BT broadband subscribers is likely to be straightforward given that subscribers are charged for the BT Sport Pack while BT Sport 1 is 'free'. In the case where the incremental revenues for the UEFA Channels cannot be easily distinguished, such as in the case of customers on Sky's pay TV platform that do not subscribe to BT broadband (where only the BT Sport Pack is available), revenues could be attributed between BT Sport 1 and the rest of the BT Sport Pack in line with sports rights' costs.

manner set out in our existing guidance and including the costs and revenues of the UEFA Channels. In other words, from this point the approach set out in our existing guidance in the VULA Margin Statement applies without any exceptions.

BT's preferred approach

2.24 Overall, BT considered that our proposals in the June 2015 VULA Consultation do not allow it sufficient flexibility and that they are disproportionate since they place a burden on BT that "*no business facing normal competitive pressures*" would face.[31] Specifically, while BT agreed that it should not be required to recover the costs of the UEFA Channels from month one, it disagreed with our designation of Deferral and Recovery Periods. BT considered that, provided the overall margin over time was sufficient to recover BT's costs, there would be no distortion of competition.[32]

2.25 BT considered that a proportionate approach would be to require the margin that BT earns across the duration of its UEFA rights contract (August 2015-May 2018) to be sufficient to recover the extra costs associated with providing the UEFA Channels. Within that period BT would have flexibility to determine the time and manner in which UEFA Channel costs are recovered. BT considered that this reflects the position that BT's competitors would face when considering whether to make the same investment as BT. BT considered that its approach would also address seasonality and take into account [✂].[33]

2.26 While the above reflects BT's preferred approach, BT also stated that, if there was a concern about the phasing of cost recovery, the distinction between the Deferral and Recovery Periods could be retained.[34]

Ofcom's assessment of the different approaches

2.27 We recognise that there may be a number of ways to address the short run issues arising in relation to the UEFA Channels as part of the VULA margin assessment. However, in order to provide BT and other stakeholders with certainty, we provide guidance on the specific treatment of the costs and revenues associated with the UEFA Channels. In doing so, we have exercised our regulatory judgement to determine the most appropriate and proportionate approach to achieve the objective of this supplementary guidance, namely dealing with atypically low take-up after the launch of the UEFA Channels whilst ensuring that the VULA margin regulation remains effective in achieving our regulatory aim.

2.28 BT proposed under its 'preferred approach' a period (i) during which it has flexibility about the *timing* of cost recovery; but where (ii) over the period as a whole BT would not have flexibility over the aggregate *amount* of cost recovery. In other words, under BT's preferred approach it cannot incur a shortfall across the period as a whole. In the light of the potential for take-up to be atypically low after the launch of the UEFA Channels, we consider that it is appropriate to have an initial phase during which BT is permitted to accumulate a shortfall – we call this the Deferral Period. However, after that phase it is necessary to ensure that BT recovers any shortfall within a reasonable period of time – we call this the Recovery Period. We consider that this structure corresponds to the nature of the issue that we have identified. Identifying a subsequent Recovery Period supports the objective of our VULA margin regulation

[31] Paragraph 39, BT response to the June 2015 VULA Consultation.
[32] Paragraphs 47-52, BT response to the June 2015 VULA Consultation.
[33] Paragraphs 72-73 and 78, BT response to the June 2015 VULA Consultation.
[34] Paragraph 76, BT response to the June 2015 VULA Consultation.

(namely addressing the risk that BT distorts competition by imposing a price squeeze) both by requiring that the costs of the UEFA Channels are recovered and by discouraging BT from accumulating a large shortfall during the Deferral Period.[35]

2.29 We consider BT's specific proposal that we should give it flexibility over the period until May 2018 as follows.

- We consider that it is appropriate to give BT flexibility over a shorter period. We consider that the initial launch period during which take-up of the UEFA Channels may be atypically low ends before May 2018 – indeed as explained in paragraph 2.49 we conclude that the length of the Deferral Period should be twelve months. We are concerned that BT is seeking additional flexibility beyond that initial launch period. Put another way, even if we were to adopt BT's approach of permitting it flexibility over the timing of cost recovery (contrary to our position set out in paragraph 2.28) the length of that period would be of the order of twelve months rather than the 34 months sought by BT.

- We are concerned that BT's proposal grants it too much scope to set a low VULA margin, potentially for several years.[36] Such flexibility gives rise to the concerns set out in the VULA Margin Statement that allowing BT to defer too much cost recovery risks undermining the effectiveness of our VULA margin regulation.[37]

- Under BT's preferred approach, we would only be able to assess whether BT complied with its obligation to maintain a VULA margin that recovers the costs of the UEFA Channels at the end of the period to May 2018. This is well beyond the end of this market review period in March 2017. Thus whether BT is ultimately required to recover these costs depends on the regulatory regime that is put in place during the next market review. While we could revisit this issue in the next market review, we are nonetheless concerned that BT's proposed approach would not give sufficient certainty as to the nature and specifics of the regulatory condition faced in this review period.

2.30 We consider that our proposal in the June 2015 VULA Consultation to designate a period during which BT can defer the recovery of the UEFA costs and to designate a separate period during which BT must recover those costs strikes an appropriate balance between the issues associated with applying our existing guidance to the special circumstances after the launch of the UEFA Channels and the risks of providing BT with too much flexibility and thereby undermining the effectiveness of our VULA margin regulation.

- While we allow BT flexibility in how it recovers the UEFA costs during the Deferral Period, we consider that this is justified given that take-up of the UEFA Channels

[35] In principal, during the Deferral Period BT could make no contribution to the incremental costs of the UEFA Channels or contribute only a very small amount. We are thus mindful that our Deferral Period may allow BT to make a lower contribution to these costs than might be expected by a normal business where there were no concerns about the harmful exercise of SMP. The duration of the Recovery Period can be used to mitigate the risk that BT makes excessive use of the flexibility afforded to it during the Deferral Period. The alternative would be specifying a proportion of the incremental costs that BT is required to recoup during each compliance period in the Deferral Period but we are concerned that specifying an appropriate level for that minimum proportion is complex and potentially arbitrary.

[36] In the extreme case, BT could defer the recovery of many of the costs associated with the UEFA Channels until 2018, allowing it to set a low VULA margin from August 2015 until that time.

[37] See paragraphs 6.292A-6.297 of the VULA Margin Statement.

may be atypically low during this period. Our proposed approach addresses this issue by allowing BT to defer some cost recovery.[38]

- However, during the Deferral Period the VULA margin must be sufficient once the incremental costs and revenues associated with the UEFA Channels are excluded. If the VULA margin were too low even when the UEFA Channels are set aside, then this risks distorting retail competition contrary to the objective of our VULA margin regulation.

- During the Recovery Period and the Final Period, we would revert to our approach set out in our existing guidance and would include the costs and revenues of the UEFA Channels. In other words, outside of the special circumstances associated with the launch of the UEFA Channels, we remain of the view that our approach set out in the guidance in the VULA Margin Statement remains appropriate and proportionate.

- Finally, our approach is consistent with our general approach, set out in the VULA Margin Statement, of requiring the VULA margin to be sufficient to recover BT's costs, since any shortfall in cost recovery during the Deferral Period must be recouped during the Recovery Period.

2.31 We note that BT itself recognised that Ofcom may have concerns about the phasing of cost recovery across the rights period and that, as a result, Ofcom may want to retain the proposed distinction between a Deferral Period and a Recovery Period.

2.32 We discuss the length of the Deferral and Recovery Periods and the rate at which BT must recoup any shortfall in paragraphs 2.34-2.65. While we discuss these topics sequentially for readability, our conclusions on these points are interrelated. Put simply, BT could be permitted scope to defer the recovery of the incremental costs of the UEFA Channels by lengthening the Deferral Period and/or by lengthening the Recovery Period and/or by giving BT more flexibility about the timing of the recovery of any shortfall during the Recovery Period. As a result, adopting a longer Deferral Period (for example) may point towards giving BT less flexibility about the time at which it recovers any resulting shortfall. This is to avoid the risk that the additional flexibility undermines the effectiveness of our VULA margin regulation by permitting BT to set a low VULA margin that distorts competition.

Conclusion on the approach to be adopted

2.33 In conclusion, we consider that the proposals in the June 2015 VULA Consultation are appropriate i.e. adopting Deferral, Recovery and Final Periods as described above.

[38] The Deferral Period is designed to be asymmetric. If, rather than incurring a shortfall during the Deferral Period, BT were to achieve a 'surplus' (i.e. if the VULA margin exceeded the minimum needed under the approach set out in the VULA Margin Statement, even when the incremental costs and revenues of the UEFA Channels are taken into account) it would not be permitted to use that surplus to set a lower VULA margin during the Recovery Period. This reflects the issue that this supplementary guidance seeks to address. If take-up in the Deferral Period is sufficiently high to avoid any shortfall then the launch issue set out in paragraph 2.17 has not arisen. As a result, the approach in the VULA Margin Statement is appropriate.

Length of the Deferral and Recovery Periods

Proposed approach in the June 2015 VULA Consultation

2.34 We provisionally concluded that the Deferral Period should be five months (i.e. August 2015 until December 2015, inclusive) and that the Recovery Period should also be five months (January 2016 to May 2016, inclusive).

Stakeholder responses

<u>BT</u>

2.35 BT considered that our proposals on the length of the Deferral Period and the Recovery Period were too short and thus disproportionately restricted BT. BT argued that our proposals rely on "*arbitrary judgements and a very weak evidence basis*". BT argued that the evidence shows that BT should have flexibility to recover the UEFA related costs over a much longer period.[39]

2.36 BT considered that, if Ofcom's framework were adopted, the Deferral Period should be no shorter than 12 months; if it were 12 months then the Recovery Period should be a further 24 months.[40]

2.37 We have grouped BT's arguments into two broad categories.

Forecast future growth

2.38 BT referred to its forecasts of future growth.

- BT referred to forecast increases in revenues in the 2016/17 and 2017/18 UEFA seasons. BT considered that [✂].[41]

- BT presented a graph showing forecast revenue and the number of BT Sport Pack subscribers for August 2015-March 2018, relative to their peaks in March 2018.[42] This shows [✂]. It also shows that [✂].

- BT stated that it will not have reached a more mature steady state by the end of our proposed Deferral Period in December 2015 and [✂] (when revenues have reached [✂] per cent of their peak level during the three seasons for which the UEFA rights are held). BT considered that this suggests a more reasonable Deferral Period is 24 months.[43]

2.39 BT considered that the data from other sports channels is not supportive of a five month Deferral Period. BT noted that [✂].[44]

2.40 BT considered that Ofcom failed to explain why, on the basis of BT's forecasts and the structure of the UEFA competition, the Recovery Period should be aligned with

[39] Paragraphs 10-11, BT response to the June 2015 VULA Consultation.
[40] BT response to the June 2015 VULA Consultation, paragraphs 13, 76-78. As discussed in paragraph 2.38, BT also suggested that the Deferral Period could be 24 months. The alternative approach that BT considered most proportionate is set out in paragraphs 2.24-2.26.
[41] Paragraphs 11, 60, 69, BT response to the June 2015 VULA Consultation.
[42] Paragraph 56, BT response to the June 2015 VULA Consultation.
[43] Paragraph 59, BT response to the June 2015 VULA Consultation.
[44] Paragraphs 63-65, BT response to the June 2015 VULA Consultation.

the end of the 2015/16 UEFA season. BT argued Ofcom's proposed Recovery Period of five months ignores forecasts of further increases in revenues in the 2016/17 and 2017/18 UEFA seasons and is therefore flawed and unduly short. BT considered that the Recovery Period should cover the 2016/17 and 2017/18 UEFA seasons.[45] BT considered that there was no evidence that a longer Recovery Period risks distorting competition.[46]

Forecast revenue fluctuations

2.41 BT also referred to forecast seasonal fluctuations in its revenues.

- BT stated that the minimum margin would be [✂] in July 2016, when no UEFA games were taking place, than in March 2016. BT stated that a Deferral Period of less than one year is unable to address these seasonal fluctuations.[47]

- BT stated that it would be "*perverse*" to start the Recovery Period (when BT has to recover any shortfall) in January 2016 due to the gap in the UEFA content [✂].[48]

<u>Other stakeholders</u>

2.42 TalkTalk agreed with the proposed length of the Deferral and Recovery Period. It considered that BT will need to rapidly build towards recovering the costs of the UEFA rights given the rights agreement lasts only three years and that BT may not retain them in the future.[49] Sky did not comment on the length of the Deferral and Recovery Periods.[50]

Evidence taken into account in reaching our decision about the length of the Deferral and Recovery Periods

<u>BT's forecasts</u>

2.43 BT provided us with a forecast of the number of subscribers to the BT Sport Pack for August 2015 – March 2018.[51] This is shown in Figure 1.1.

Figure 1.1: Forecast volumes for BT Sport Pack ('000s)

[✂]

Source: Ofcom chart produced using BT response to question 2 of the s.135 notice of 12 May 2015

2.44 Table 1.1 presents BT's forecast for total BT Sport Pack subscribers, the monthly change in those subscribers and subscribers as a percentage of the forecast peak in overall subscriber numbers in [✂].

[45] Paragraphs 69-70, BT response to the June 2015 VULA Consultation. In subsequent communication, BT made clear that its position was without prejudice to the stance taken in its appeal of the VULA margin regulation.
[46] Paragraph 77, BT response to the June 2015 VULA Consultation.
[47] Paragraphs 61 and 72 (1st bullet), BT response to the June 2015 VULA Consultation.
[48] Paragraph 62, BT response to the June 2015 VULA Consultation.
[49] TalkTalk response to the June 2015 VULA Consultation.
[50] Paragraph 3, Sky response to the June 2015 VULA Consultation.
[51] [✂] BT response to question 2 of the s.135 notice of 12 May 2015.

2.45 Table 1.2 presents BT's forecast for the incremental "*direct monetisation*" of the BT Sport Pack (over and above BT Sport 1).[52] This forecast assumes that [✂].[53] The key drivers of [✂].[54] Table 1.2 also smooths BT's forecasts using the approach set out in the VULA Margin Statement.[55] Our approach to smoothing removes a significant part of the seasonal volatility.[56]

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[52] Table 1.2 excludes the extra profits BT forecast that it will earn from supplying broadband and other services to subscribers that are attracted by the BT Sport Pack (i.e. indirect monetisation).

[53] BT response to question 10 and Annex 3 of the s.135 notice of 12 May 2015.

[54] BT response to question 1b of the s.135 notice of 22 July 2015. In response to question 2 of this notice [✂].

[55] If the revenues in month 6 (say) are less than in month 1 then the average revenues for months 1 to 6 are used; otherwise the month 6 figure is used. Paragraphs 6.310-6.312, VULA Margin Statement.

[56] BT argued that forecast revenues in July 2016 (when no live UEFA matches are broadcast on the UEFA Channels) are [✂] than in March 2016. However, once smoothing is applied the difference between July 2016 and March 2016 is only [✂]. Therefore, our approach to smoothing the seasonal variation by using six month averages removes nearly [✂] of seasonal volatility. Using the data on BT's superfast broadband subscriber and BT Sport subscriber numbers for April 2015, this variation is equivalent to [✂] change in BT's monthly margin. BT's Compliance Statement for the period from 1 April 2015 to 30 April 2015 (inclusive).

Table 1.1: Forecast volumes for BT Sport Pack

	Total BT Sport pack subscribers ('000)	Change in BT Sport Pack subscribers ('000)	BT Sport Pack subscribers as % of peak
Aug-15	[✂]		[✂]
Sep-15	[✂]	[✂]	[✂]
Oct-15	[✂]	[✂]	[✂]
Nov-15	[✂]	[✂]	[✂]
Dec-15	[✂]	[✂]	[✂]
Jan-16	[✂]	[✂]	[✂]
Feb-16	[✂]	[✂]	[✂]
Mar-16	[✂]	[✂]	[✂]
Apr-16	[✂]	[✂]	[✂]
May-16	[✂]	[✂]	[✂]
Jun-16	[✂]	[✂]	[✂]
Jul-16	[✂]	[✂]	[✂]
Aug-16	[✂]	[✂]	[✂]
Sep-16	[✂]	[✂]	[✂]
Oct-16	[✂]	[✂]	[✂]
Nov-16	[✂]	[✂]	[✂]
Dec-16	[✂]	[✂]	[✂]
Jan-17	[✂]	[✂]	[✂]
Feb-17	[✂]	[✂]	[✂]
Mar-17	[✂]	[✂]	[✂]
Apr-17	[✂]	[✂]	[✂]
May-17	[✂]	[✂]	[✂]
Jun-17	[✂]	[✂]	[✂]
Jul-17	[✂]	[✂]	[✂]
Aug-17	[✂]	[✂]	[✂]
Sep-17	[✂]	[✂]	[✂]
Oct-17	[✂]	[✂]	[✂]
Nov-17	[✂]	[✂]	[✂]
Dec-17	[✂]	[✂]	[✂]
Jan-18	[✂]	[✂]	[✂]
Feb-18	[✂]	[✂]	[✂]
Mar-18	[✂]	[✂]	[✂]

Source: Ofcom calculations using BT response to question 2 of the s.135 notice of 12 May 2015

Table 1.2: Forecast incremental BT Sport Pack direct monetisation (£m)

	Forecast (unadjusted)	Forecast (smoothed)
Aug-15	[✂]	[✂]
Sep-15	[✂]	[✂]
Oct-15	[✂]	[✂]
Nov-15	[✂]	[✂]
Dec-15	[✂]	[✂]
Jan-16	[✂]	[✂]
Feb-16	[✂]	[✂]
Mar-16	[✂]	[✂]
Apr-16	[✂]	[✂]
May-16	[✂]	[✂]
Jun-16	[✂]	[✂]
Jul-16	[✂]	[✂]
Aug-16	[✂]	[✂]
Sep-16	[✂]	[✂]
Oct-16	[✂]	[✂]
Nov-16	[✂]	[✂]
Dec-16	[✂]	[✂]
Jan-17	[✂]	[✂]
Feb-17	[✂]	[✂]
Mar-17	[✂]	[✂]
Apr-17	[✂]	[✂]
May-17	[✂]	[✂]
Jun-17	[✂]	[✂]
Jul-17	[✂]	[✂]
Aug-17	[✂]	[✂]
Sep-17	[✂]	[✂]
Oct-17	[✂]	[✂]
Nov-17	[✂]	[✂]
Dec-17	[✂]	[✂]
Jan-18	[✂]	[✂]
Feb-18	[✂]	[✂]
Mar-18	[✂]	[✂]

Source: Ofcom calculations using BT response to question 2 of the s.135 notice of 12 May 2015

The structure of the UEFA football competitions

2.46 The most attractive content on the UEFA Channels is likely to be UEFA Champions League and Europa League football matches (as shown by the large amount BT paid for the rights to this content).

- The Champions League has a group stage (96 matches) between 15 September and 9 December 2015. This stage will involve at least three and possibly four

English clubs.[57] The final knockout phase (29 matches) is between 16 February and 28 May 2016. The number of English clubs involved in this stage and how far they progress depends on their performance.[58]

- The Europa League has a group stage (144 matches) between 17 September and 10 December 2015.[59] There is then a pause in the contest. The final knockout phase (61 matches), which includes clubs that failed to progress in the Champions League, is between 18 February and 18 May 2016.[60]

Performance of other sports pay TV channels

2.47 We also have data on the actual performance of other sports pay TV channels which shows the number of paying subscribers to Setanta Sports, ESPN and BT Sport on Sky's pay TV platform.[61] We make the following observations about this evidence.

- [✂] The profile of growth in subscribers differs between the three channels.
- [✂].
- [✂].

Ofcom's assessment of the evidence

2.48 Before setting out our conclusions on the length of the Deferral and Recovery Period we make the following observations on how we have interpreted the evidence set out above.

- Although we are departing from the guidance set out in the VULA Margin Statement in order to reflect the special circumstances that may arise in the period after launch of the UEFA Channels, we are mindful of the concerns set out in that statement that allowing BT to defer cost recovery could risk undermining the effectiveness of our VULA margin regulation.[62]

- BT considered that our approach to the Deferral and Recovery Periods failed to take account of the future growth in revenues that it forecast. We recognise that

[57] Prior to this group stage there is a qualifying stage. This involves one English club. In the last five seasons, four English clubs have been involved at the group stage.
[58] In the last five seasons, between two and four English clubs have progressed beyond the group stage. In two seasons (2012/13 and 2014/15) all English clubs were knocked out in the first round of the knockout phase. In two seasons (2010/11 and 2011/12) an English club progressed to the final.
[59] Prior to this group stage there is a qualifying stage. In the last five seasons, up to four English clubs have been involved in the qualifying stage and one to three English clubs have been involved in the group stage.
[60] In the last five seasons, between two and four English clubs been involved beyond the group stage. In one season (2012/13) an English club progressed to the final.
[61] The data for Setanta covers August 2007 to May 2008 and was requested on a non-statutory basis for a historic Ofcom project. Accordingly, our observations of other channels' performance after May reflect ESPN and BT Sport but not Setanta. We have two sets of data from ESPN. The first set of data covers August 2009 to March 2011 and was requested on a non-statutory basis for a historic Ofcom project. The second set of data was obtained from BT (which purchased the ESPN UK channels in 2013) and covers the period June 2010 to June 2013. The two sets of ESPN figures are broadly similar but the precise figures differ. The data for BT Sport covers the period from August 2013. Sources: Setanta response to question 3 of the information request of 27 June 2007; ESPN response to question 2 of the information request of 18 May 2011; BT response to question 1 of the s.135 notice of 2 July 2015; BT response to question 1 of the s.135 notice of 21 October 2014.
[62] Paragraph 6.292B, VULA Margin Statement.

revenues from the UEFA Channels may increase over time. However, as explained in the VULA Margin Statement, there are challenges in evaluating how well founded forecasts of this nature are likely to be. Moreover, taking forecast growth into account risks incorporating the outcome of a distortion of competition.[63]

- BT also argued that the revenues from the UEFA Channels are expected to fluctuate [✂] during the year and this should be taken into account when deciding on the duration of both the Deferral and the Recovery Periods. We have taken into account the structure of the UEFA contests (e.g. gaps when no matches are played). This structure is also reflected in the forecasts that BT provided and which we also take into account. However, to reiterate, we are departing from the guidance in the VULA Margin Statement to reflect the issues associated with atypically low take-up of the UEFA Channels after launch. We are not doing so to address issues of seasonality more generally.[64]

Ofcom's assessment of the length of the Deferral Period

2.49 Determining the length of the Deferral Period involves the exercise of judgment. In light of the above evidence and the responses to the June 2015 VULA Consultation, we conclude that an appropriate and proportionate length for the Deferral Period is twelve months (i.e. August 2015 until July 2015, inclusive).

- We do not agree with BT that we should attempt to estimate when the UEFA Channels reach a "*steady state*" (a process that potentially takes a very long and uncertain amount of time, if it is attained at all). This is consistent with our more general approach in the VULA Margin Statement which did not attempt to model BT's position in a future steady state. As set out in paragraphs 2.14-2.19, we are considering a narrow set of circumstances relating to the launch of the UEFA Channels.

- In line with paragraph 2.18, the Deferral Period reflects the period following launch of the UEFA Channels during which take-up may be atypically low. It is not the entirety of the period over which growth is expected to occur. As shown in Table 1.1, BT forecasts that between April to July 2016 volumes will be at [✂] to [✂] per cent of the overall peak.[65] Thus by this time [✂] and we consider that take-up would no longer be atypically low. This suggests that the Deferral Period should end around this time.

[63] BT forecasts that [✂] of the incremental revenues associated with the BT Sport Pack come [✂]. In addition, based on BT's forecasts, the majority of the growth in revenues from the UEFA Channels will be driven by [✂]. For example, BT forecasts show that the revenues in 2017/18 are [✂]. This is primarily due to [✂]. BT's forecasts also show that the total number of the subscribers to the BT Sport Pack will [✂] (BT response to question 2 of the s.135 notice of 12 May 2015). [✂] (BT response to question 10 of the s.135 notice of 12 May 2015). The risks to the effectiveness of our VULA margin regulation are explained in paragraphs 6.292B-6.297, VULA Margin Statement.

[64] Our general approach to dealing with the seasonal volatility in BT's costs and revenues is set out in paragraphs 6.35, 6.35B and 6.312, VULA Margin Statement.

[65] We have focused on BT's forecasts and placed less weight on the performance of other sports pay TV channels. This is because the latter evidence (i) relates to the take-up of channels on Sky's pay TV platform by paying subscribers whereas an important aspect of BT's business model is take-up by (paying) broadband subscribers; and (ii) these channels broadcast live FA Premier League football matches, so the fixture list for the key sporting competition is structured differently to Champions League and the Europa League.

- As shown in Table 1.2, BT forecast that direct incremental revenues from the BT Sport Pack would [✂]. While our approach to smoothing revenues dampens seasonal changes, we recognise that once the Deferral Period ends BT will need to set a sufficient margin to both (i) recover its monthly costs (including the costs of the UEFA Channels) in accordance with the guidance set out in the VULA Margin Statement; and (ii) begin recovering any shortfall. This suggests that it is appropriate for the Deferral Period to end in July 2016 so that the Recovery Period begins in August 2016 when [✂] and the play off stage to qualify for the Champions League and Europa League occurs.

- We also consider that a twelve month Deferral Period reflects a reasonable way for a business to approach this issue. Given the UEFA football contests repeat annually and that BT only holds the rights for three seasons, a one year period represents a natural break between the initial launch phase and point at which the new European sports proposition should begin recouping any initial costs.

2.50 BT argued that the Deferral Period should be at least twelve months.[66]

2.51 The twelve month period we conclude is appropriate is longer than the five month Deferral Period we proposed in the June 2015 VULA Consultation. In reaching our final view, we have applied the same underlying principles as in that consultation i.e. judging the point at which the initial launch phase for the UEFA Channels ends. There are a number of potential options for the length of this period. Having taken account of the submissions from BT and reconsidered the evidence in light of these submissions, we think there is merit in BT's view that a more appropriate and proportionate approach is to consider that the launch phase of the UEFA channels covers their entire first season.

Ofcom's assessment of the length of the Recovery Period

2.52 Determining the length of the Recovery Period also involves the exercise of judgment. Having considered the evidence and the responses to the June 2015 VULA Consultation, we conclude that an appropriate and proportionate length for the Recovery Period is nine months (i.e. August 2016 to April 2017, inclusive).

- BT suggested a Recovery Period of 24 months, to cover the remaining duration of its rights to UEFA football.[67] We are keen to ensure that our VULA margin regulation remains effective in achieving our regulatory aim. Part of BT's justification for a 24 month Recovery Period was the [✂]. We are concerned that allowing BT to set a low margin in 2015/16 supported by [✂] risks enabling the behaviour that our VULA margin regulation is seeking to prevent.[68] Moreover, we are concerned that a long Recovery Period may encourage BT to set a lower margin in the Deferral Period since it has more time over which to recoup any shortfall.[69] A longer Recovery Period thus increases the risk that the effectiveness of our VULA margin regulation is undermined. Accordingly we consider that the 24 month Recovery Period suggested by BT is too long.

- Notwithstanding the above, we recognise that, should BT accumulate any shortfall in the Deferral Period, it would be required to set a larger VULA margin than under the approach set out in the VULA Margin Statement to recover that

[66] Paragraph 77, BT response to the June 2015 VULA Consultation.
[67] Paragraph 77, BT response to the June 2015 VULA Consultation.
[68] Paragraphs 6.293-6.294, VULA Margin Statement.
[69] See the concern set out in the footnote to paragraph 2.28.

additional shortfall. We are therefore mindful that the length of the Recovery Period should not be unduly short.

- We consider that the Recovery Period should extend until at least December 2016. As set out in Table 1.1, [✂]. An uptick in paying subscribers at the start of the second season is also consistent with the experience of other sports channels. Accordingly, this seems like a reasonable minimum for the period over which any shortfall must be recovered.

- However, we have considered whether to extend the period over which any shortfall must be recovered beyond December 2016. BT forecast that in the 2016/17 UEFA season [✂].[70] The 2016/17 UEFA season finishes in mid-May 2017 so, given the schedule for these matches, from a commercial perspective it seems plausible that from the middle of that month some consumers will seek to end their BT Sport subscription [✂] and the rate of (gross) subscriber additions will slow. Given that each compliance period represents a complete calendar month and April 2017 is the last full month during which BT broadcasts UEFA football during the 2016/17 season, this suggests that the Recovery Period should end in April.

- On balance, we consider that extending the Recovery Period beyond December 2016 until April 2017 is appropriate and proportionate. It allows BT the bulk of the 2016/17 season to recover any shortfall accumulated during the Deferral Period. In our judgment, this balances between allowing BT the scope to incur some shortfall during the Deferral Period while not being so long as to undermine the objective of our VULA margin regulation.

2.53 We recognise that ending the Recovery Period in April 2017 takes us one month beyond the end of the current market review period in March 2017. In the event that BT does accumulate a shortfall during the Deferral Period and some of that shortfall is not recovered during the current market review, then we will need to take into account the existence of any such unrecovered shortfall when considering how, if at all, to regulate VULA after March 2017 as part of our next market review.[71]

Further details on the calculation and recovery of any shortfall

2.54 We now set out in more detail how the shortfall should be calculated at the end of the Deferral Period and discuss how that shortfall should be recovered during the Recovery Period.

Proposed approach in the June 2015 VULA Consultation

2.55 In the June 2015 VULA Consultation we proposed that, if there is a shortfall during the Deferral Period, we would calculate an additional fixed amount that BT must recover each month during the Recovery Period that would have the same NPV as the total shortfall. If there was no shortfall during the Deferral Period, no adjustment would be made in the Recovery Period.

[70] [✂].
[71] Given that the Recovery Period only extends one month beyond the end of this market review, the concerns in paragraph 2.29 have less force. In particular since eight of the nine months of the Recovery Period will have elapsed and, as explained below at paragraphs 2.63-2.65, we are requiring BT to recover any shortfall during each month in the Recovery Period on a straight-line basis (or faster), by the end of March 2017 BT should have recovered at least 89% (i.e. $^8/_9$) of any shortfall.

Stakeholder comments

2.56 BT observed that the approach proposed in the June 2015 VULA Consultation potentially places an additional requirement on BT during the Recovery Period.[72] BT stated that, where superfast broadband subscriber numbers are growing, requiring a constant £m amount to be recovered in each month of the Recovery Period (to make up for a shortfall in the Deferral Period) means the per subscriber impact is declining. BT considered that such a pattern of cost recovery is not commercially rational.[73]

2.57 BT was also concerned that the minimum VULA margin may vary seasonally and gave as an example the absence of UEFA football matches in January 2016, the first half of February 2016 and the latter half of May 2016.[74] BT considered that it should have flexibility over the time at which net losses are recovered during the Recovery Period, rather than be required to make a fixed additional contribution being added each month.[75]

2.58 BT also explained that, by requiring a fixed amount of any shortfall to be recovered in each month of the Recovery Period, Ofcom's approach would ignore any net 'surplus' earned during a particular month. It stated that, if certain monthly cohorts contribute additional 'surplus' margin, then it is unclear why other cohorts could not make lower contributions. BT submitted that it is not clear why any such monthly 'failure' could be considered distortive provided the overall margin over time was sufficient to recover the fixed rights costs.[76]

Ofcom's approach

2.59 During the Recovery Period the VULA margin in each compliance period must be sufficient to recover BT's costs, calculated in accordance with our existing guidance and including the costs and revenues of the UEFA Channels. The outstanding issue is how to calculate the additional VULA margin necessary to recover any shortfall that accumulated during the Deferral Period:

- the approach set out in the June 2015 VULA Consultation requires a constant £m contribution in each month of the Recovery Period; while
- in contrast, BT sought flexibility over the contribution that it must make to the shortfall during each month of the Recovery Period.

2.60 In principle, both these options could achieve the aim of requiring BT to recover any shortfall by the end of the Recovery Period.[77]

2.61 As explained in paragraph 2.32, the amount of flexibility over the timing of the recovery of any shortfall is interrelated with our decision on the length of the Deferral and Recovery Periods. In the light of the duration of those periods we are concerned

[72] Paragraphs 9 and 34, BT response to the June 2015 VULA Consultation.
[73] Paragraph 53, BT response to the June 2015 VULA Consultation.
[74] Paragraphs 50-52, BT response to the June 2015 VULA Consultation.
[75] Paragraph 13, BT response to the June 2015 VULA Consultation.
[76] Paragraph 49, BT response to the June 2015 VULA Consultation.
[77] Given that our Recovery Period ends in April 2017, after the current market review, if we were to adopt the flexible approach advocated by BT it would be necessary require BT to have recovered an appropriate proportion of any shortfall by the end of March 2017.

that BT's proposal gives it too much flexibility which would risk undermining the effectiveness of our VULA margin regulation.[78]

- During the twelve month Deferral Period, BT would be free to set a margin that does not reflect the incremental costs of the UEFA Channels. If we were to permit further flexibility across the Recovery Period, the risk is that a large proportion of these costs may not begin to be recovered until early 2017, i.e. nearly one and a half years after the UEFA Channels launched. This is a particular concern given that our Deferral Period may allow BT to make a lower contribution to the incremental costs of the UEFA Channels than might be expected by a normal business (see footnote to paragraph 2.28).

- BT was concerned about seasonality. However, we do not consider that this justifies its approach. In particular our Recovery Period excludes May, June and July 2017, i.e. the period after the end of the 2016/17 UEFA season in mid-May. Moreover, while BT was concerned about the impact of the gap in UEFA football in January and February 2017, [✂].

2.62 The approach set out in the June 2015 VULA Consultation ensures that BT begins recouping any shortfall immediately and does so at a steady rate. Given that the Deferral Period is twelve months (encompassing the entirety of one of the three seasons of UEFA football that BT has the rights to) and that it has a further nine months to recoup any shortfall, we do not think it is appropriate to provide BT with further flexibility to defer the recovery of any shortfall. Indeed, during that twelve-month Deferral Period BT has considerable flexibility over how much of a contribution to make to the incremental costs of the UEFA Channels. Moreover, the approach set out in the June 2015 VULA Consultation is in line with the general approach in the VULA Margin Statement of identifying what costs (and therefore what minimum VULA margin) BT needs to recover each month.

2.63 However, in response to BT's comments, we consider it appropriate to make an adjustment to the approach in the June 2015 VULA Margin Consultation to allow BT to recoup any shortfall faster if it wishes. In contrast to the case where BT is further deferring the recovery of its costs, recovering any shortfall more quickly does not give rise to the risk that the objective of our VULA margin regulation is undermined.

2.64 In conclusion, we consider that it is appropriate and proportionate to adopt a modified version of the approach we proposed in the June 2015 VULA Margin Consultation that allows BT to recoup any shortfall sooner.

2.65 The following detailed steps below describe how the shortfall will be calculated at the end of the Deferral Period and how we will assess whether that shortfall is recovered during the Recovery Period.[79]

- Step 1: To calculate the shortfall, for each compliance period during the Deferral Period we would calculate (in £m) the increase or decrease in the net cost of BT Sport allocated to superfast broadband subscribers that would result in BT being on the boundary between passing and failing the margin assessment under the approach set out in the VULA Margin Statement.

[78] Similar concerns would also arise were we to give BT flexibility to recover the shortfall by requiring a constant £m contribution periodically over the Recovery Period (but in periods greater than one month).
[79] The discount rate would be equal to the monthly pre-tax nominal WACC relevant to the BT Consumer business prevailing in the compliance period.

- Step 2: At the end of the Deferral Period, the total shortfall (in £m) is the sum of the net present value ('NPV') of all the monthly figures calculated at Step 1. This effectively nets off months during the Deferral Period that 'over-recover' (under the approach set out in our existing guidance) against months that 'under-recover'. A total shortfall exists if any decreases in the net cost calculated at Step 1 outweigh any increases.

- Step 3: If, at the end of the Deferral Period, there is a total shortfall then we would adopt the following iterative process:

    - Step 3.1: During the first compliance period in the Recovery Period, we would calculate what monthly £m amount has, over the remainder of the Recovery Period, the same NPV as the total shortfall. During that compliance period, that monthly £m amount would be added to the £m net cost of BT Sport allocated to superfast broadband subscribers. That monthly £m amount thus forms part of the minimum margin that BT must maintain during that compliance period.

    - Step 3.2: At the end of the first compliance period in the Recovery Period we would calculate the increase in the net cost of BT Sport allocated to superfast broadband subscribers that would result in BT being on the boundary between passing and failing the margin assessment under the approach set out in the VULA Margin Statement. That amount (in £m) shows the actual amount of the shortfall recovered during that compliance period. That amount would be deducted from the total shortfall to give a new figure for the outstanding total shortfall that is used in the next compliance period.

    - Step 3.3: This process is then repeated in the second and subsequent compliance periods in the Recovery Period. At the start of each compliance period the outstanding figure for the total shortfall is used to calculate the increase in the £m net cost of BT Sport allocated to superfast broadband subscribers (as in Step 3.1). At the end of each compliance period the figure for the total shortfall is revised (as in Step 3.2).[80]

- Step 3 (continued): If, at the start of any compliance period during the Recovery Period, there is no total shortfall then no adjustment is made. In these circumstances it is appropriate and proportionate to return to the approach set out in our existing guidance in the VULA Margin Statement.[81]

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[80] To illustrate (and ignoring discounting for simplicity of exposition), if the total shortfall at the end of the Deferral Period were £18m then during the first month of the Recovery Period BT would be required to recover an additional £2m (i.e. £18m spread across the nine months of the Recovery Period). If BT did not then it would breach our VULA margin condition. However if in fact BT recovered an additional £6m during the first month of the Recovery Period then the total shortfall remaining at the start of the second month of the Recovery Period would be £12m. As a result, in that second month BT would be required to recover an additional £1.5m (i.e. £12m spread over the eight remaining months).

[81] To illustrate if the total shortfall at the end of the Deferral Period were £18m and during the first month of the Recovery Period BT recovered an additional £20m (i.e. an amount larger than the total shortfall) then in subsequent months it would not have to make any adjustments. However, BT would not be permitted to reduce the VULA margin below the minimum implied by our existing guidance in the VULA Margin Statement.

Supplementary guidance

2.66 In light of the above, our supplementary guidance is as follows.

> **Supplementary guidance**
> During the August 2015 to July 2016 (inclusive) compliance periods ('the Deferral Period'), we would assess the VULA margin in accordance with the rest of our guidance except that the incremental costs and revenues associated with the UEFA Channels (BT Sport 2, BT Sport Europe and ESPN) are excluded.
>
> During the August 2016 to April 2017 (inclusive) compliance periods ('the Recovery Period'), we would assess the VULA margin in accordance with the rest of our guidance, including the incremental costs and revenues associated with the UEFA Channels, but with an adjustment to reflect the Total Shortfall.
>
> The adjustment to reflect the Total Shortfall would be calculated as follows.
> - For each compliance period during the Deferral Period, we would calculate (in £m) the increase or decrease in the net cost of BT Sport allocated to superfast broadband subscribers that would result in BT being on the boundary between passing and failing the margin assessment under the approach set out in the rest of our guidance.
> - The Total Shortfall at the end of the Deferral Period (in £m) is the sum of the NPV of all those monthly decreases less the sum of the NPV of all those monthly increases. A Total Shortfall exists if the monthly decreases outweigh the monthly increases.
> - At the start of any compliance period during the Recovery Period, if there is a Total Shortfall then we would calculate what monthly £m amount has, over the remainder of the Recovery Period, the same NPV as the Total Shortfall. During that compliance period that monthly £m amount would be added to the £m net cost of BT Sport allocated to superfast broadband subscribers. At the end of that compliance period we would calculate (in £m) the increase in the net cost of BT Sport allocated to superfast broadband subscribers that would result in BT being on the boundary between passing and failing the margin assessment under the approach set out in the rest of our guidance. That amount would be deducted from the Total Shortfall to give a new figure from the Total Shortfall that is used in the next compliance period.
> - If no Total Shortfall exists during any compliance period during the Recovery Period (either because no shortfall was accumulated during the Deferral Period or because an amount equal to or greater than any shortfall has been recouped earlier in the Recovery Period) then no adjustment is made.
> - The discount rate used in this calculation would be equal to the monthly pre-tax nominal WACC relevant to the BT Consumer business prevailing in the compliance period.

BT request for further guidance on other matters

BT's comments

2.67 Beyond the specific circumstances in the consultation, BT considered that greater clarity is needed about how the VULA margin will be assessed in the light of other material changes in circumstances [✂] (BT did not elaborate on what these are). BT considered that assessing each future material change in circumstances on a case-by-case basis creates significant and unnecessary regulatory uncertainty. BT also referred to the risk of commercial failure. To illustrate, BT described a scenario in which revenues from BT Sport are low, meaning that the price of BT's superfast broadband bundles would need to increase (in order to meet the minimum VULA margin condition) which would weaken BT's position in the broadband market and might result in a "*downward spiral*". BT sought further guidance on how Ofcom would deal with these circumstances.[82]

Ofcom's position

2.68 As set out in paragraph 6.5 of the VULA Margin Statement, the guidance reflects our current view of the most appropriate approach under the existing circumstances. While we recognise that material changes to circumstances may occur, we do not think it would be appropriate, nor in many cases possible, to provide in advance detailed guidance on our approach in every possible eventuality. BT has not specified the specific material changes in circumstances that it anticipates will occur. Given any future material changes to circumstances are speculative and unknown to us at this stage, we do not consider that we can provide additional guidance as to the approach we would be likely to adopt as we would need to consider any material changes of circumstances on a case-by-case basis. We note that we did provide additional details on how we may respond flexibly to a material change in circumstance in the VULA Margin Statement.[83]

2.69 BT also requested additional guidance in relation to how we 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. In the event that the actual circumstances surrounding the UEFA Channels were to develop in an exceptional way, including in respect of commercial failure, we may need to reassure ourselves that the application of our guidance remains appropriate. We also note that we set out our approach in the circumstances where BT Sport is loss making in aggregate in paragraphs 6.280-6.289 of the VULA Margin Statement.

[82] Paragraphs 14-15, 17 (second bullet), 35, and 80-84, BT response to the June 2015 VULA Consultation.
[83] Paragraphs 6.25-6.25A, VULA Margin Statement.

Annex 1

Equality Impact Assessment

A1.1 Annex 2 of the 2014 FAMR Statement sets out our Equality Impact Assessment ('EIA') for the Fixed Access Market Reviews. We consider that assessment to apply equally to the proposals set out in this document (which themselves form part of our reviews of the fixed access markets). Ofcom is required by statute to assess the potential impact of all our functions, policies, projects and practices on race, disability and gender equality. EIAs also assist us in making sure that we are meeting our principal duty of furthering the interests of citizens and consumers regardless of their background or identity.

A1.2 It is not apparent to us that the outcome of our proposals is likely to have any particular impact on race, disability and gender equality. Specifically, we do not envisage the impact of any outcome to be to the detriment of any particular group of society. Nor do we see any need to carry out separate EIAs in relation to race or gender equality or equality schemes under the Northern Ireland and Disability Equality Schemes.