Fixed access market reviews: VULA Margin Squeeze Regulation Reporting Obligations

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TalkTalk response

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1 Summary

1.1 This short submission responds to Ofcom's proposals for a reporting obligation on BT in respect of the VULA margin.

1.2 We strongly support Ofcom's proposed margin squeeze reporting obligation since it will help to prevent margin squeezes occurring if it is imposed alongside a pre-launch test. If it is not combined with pre-launch testing then margin squeezes may not be detected for many months after products are launched, leading to weakened competition and consumer detriment.

1.3 In order for the margin squeeze reporting obligation to be effective Ofcom will need to be very prescriptive about how the costs and revenues are presented, limiting BT's ability to game the system. In particular, Ofcom will need to specify the level of aggregation at which the test is applied, how the costs are derived and adjusted to reflect entrants' costs, the level of audit and sign-off and the timing and frequency of the reports.

1.4 In this response we briefly recap on the pressing need for, and objectives of, margin squeeze regulation of superfast broadband products, how a reporting obligation can fit in with other aspects of the regulation, and provide some comments on the detail of the obligation e.g. on what basis should the costs that BT reports be derived, how frequently should BT report.

2 Need for margin squeeze regulation and role of reporting

2.1 In TalkTalk's September 2013 response to Ofcom's July 2013 FAMR consultation we outlined our view on the need for margin squeeze regulation and the form that such regulation should take. The key points we made were:

- BT has a strong commercial incentive to engage in anti-competitive margin squeeze and, in our view, BT is engaged in an on-going margin squeeze. Ofcom is currently investigating BT since it has 'reasonable suspicion' that BT has engaged in a margin squeeze in contravention of the Competition Act.
- The margin squeeze has resulted in part from BT setting an excessive wholesale price. The GEA wholesale price averages about £8 to £9 yet, based on recent capex data, it is clear that the GEA cost is no more than about £3[1].
- There is a need for incisive and firm regulation that will genuinely prevent BT from margin squeezing – this should prevent margin squeezes from occurring rather than just detecting (and then stopping) squeezes some months or years

[1] WIK provided an analysis of the cost of GEA based on a capex of £2.4bn for its commercial roll-out (which was similar to BT's claims of £2.5bn). BT has said that the fibre capex run rate is £300m to £400m a year. Given BT started rolling out slowly in late 2010 and will finish in Spring 2014. Based on this we estimate the total capex to be about £1.4bn. Even that lower amount is not apparent in BT's RFS, which imply that the cost of commercial roll-out may be less than £500m.

after they first occurred. We believe that margin squeeze regulation (rather than wholesale price regulation) is, at this point in time, the most suitable regulatory tool to meet this aim.

- For margin squeeze regulation to be effective it needs to meet a number of objectives: be effective in preventing margin squeezes occurring; be robust to gaming by BT; be flexible to adapt to new products and changing market conditions; and be transparent and predictable. If not carefully designed with these objectives in mind there would be a real risk that margin squeeze regulation could be ineffective in practice.
- Ofcom proposed three options for how margin squeeze regulation could operate[2]. Though these all had certain merits we considered that they would not be sufficiently effective as they could only detect a margin squeeze several months after BT launched products[3]. We proposed an approach based on BT pre-testing its products before launch and when there was a material change in the test inputs (e.g. cost change, price/promotion change)[4].

2.2 We think that Ofcom's proposed reporting obligation is a useful tool which (if effectively implemented) can help detect margin squeeze. We therefore welcome this proposal.

2.3 However, by its very nature a reporting obligation operates 'after the event'. It is unlikely on its own to properly and quickly deter margin squeezes from occurring for a number of reasons[5]:

- it cannot detect a margin squeeze before launch or prevent BT from launching a product that margin squeezes
- if BT do launch a product that margin squeezes it can be 6 months (or more) before the squeeze is detected. Pre-launch testing would avoid any delay due to the gap between product launch and the next of BT's regular semi-annual marginal squeeze updates to Ofcom.
- Without pre-launch testing, BT could [engage in gaming behaviours ✂].

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[2] Ofcom's options (from §11.373) were:
- Option 1: CPs could bring dispute if felt a product was margin squeezing
- Option 2: Ofcom would systematically test product some months after they were launched
- Option 3: a fixed £ margin was set

The first two options were likely to be ineffective since they did not prevent margin squeezes and could only (like a Competition Act investigation) detect a margin squeeze some months after it occurred. The last option was likely to be ineffective since the appropriate (absolute) margin was likely to vary from product to product

[3] This is the case for options 1 and 2, Option 3 could avoid a squeeze at launch however setting a fixed £ margin was likely to be ineffective since the appropriate margin was likely to vary

[4] Such a pre-launch test would be based on Ofcom's assumptions. BT would file the results of the test with Ofcom

[5] A further problem might be that it could take a little time for the rule to be fully prescribed and therefore 'bite'

2.4 Therefore, we consider the reporting obligation as <u>a complement, not an alternative</u>, to the pre-launch testing by BT[6] which can confirm compliance with margin squeeze regulation.

2.5 A reporting obligation will be most effective in detecting and deterring margin squeezes by Ofcom if it is very prescriptive from the outset about how the costs are derived (discussed below) in order to avoid BT gaming the system, and also has strong and clear fines or other sanctions in the case of a breach. In the absence of both of these a reporting obligation, whilst welcome, may have limited effect in deterring margin squeezes (particularly in the short term).

3 Design of the reporting obligation

3.1 In this section we discuss how the reporting obligation should be designed and specified in order that it is most effective in detecting margin squeeze.

3.2 We understand that the reporting obligation will require BT to present BT Retail's[7] revenue and costs for VULA products (including the wholesale prices notionally 'paid' to Openreach and BT Retail's own retailing costs) and if the revenue equals or exceeds the cost then there is no margin squeeze.

3.3 We discuss a number of aspects of how such a reporting obligation should be specified and designed in order that it will have maximum effect. Margin reporting is inherently a more complex exercise than, say, charge control monitoring which only needs to monitor prices against a ceiling[8]. The VULA margin obligation will need to monitor revenues and costs (the later which can be determined in many different ways) against the need to ensure a positive margin.

3.1 Level of aggregation

3.4 The level of (dis)aggregation of the reporting should match that which Ofcom determines should be used – for example, if Ofcom requires that (for example) a basket of Infinity 1 with TV products should (by themselves) pass the margin squeeze test then BT should provide data that matches this group. TalkTalk proposed previously that the test should be conducted on each of six 'core product groups'. We believe that this is a sensible balance between on the one hand preventing gaming by BT[9] and anti-competitive targeting of particular competitors and on the other avoiding excessive administrative burden and preventing genuine innovation by BT.

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[6] As we explained in our Sept submission the pre-launch product test should be complemented by testing of the product if there is a material change in the revenue or costs (that would reduce the margin).

[7] We refer to BT Retail as the entity that purchases from Openreach. In practice BT Wholesale consumes the GEA product and adds some other functionality e.g. backhaul, peering to Internet and passes this to BT Retail.

[8] Or in the case of a basket the average price change against a price change ceiling.

[9] The larger the group of products the greater the opportunity for BT to game the system by [✂].

3.5 We also believe that it will be important that the price used by BT in its margin squeeze submissions to Ofcom is not the headline price published by BT, but is instead the actual price charged to consumers, including any *ad hoc* discounts given. [✂].

3.2 Assumptions used to derive costs

3.6 The costs information reported by BT must be based on Ofcom's assumptions about how the costs should be derived for the margin squeeze test e.g.

- Costs should be based on incremental costs plus a share of relevant common costs.
- Costs should be adjusted to reflect the higher unit costs of an entrant due, for example, to lower market share (i.e. a REO type test). This means that the costs reported by BT will not be BT's own 'raw' costs but will be BT's costs adjusted in a pre-specified manner.
- Costs should include content costs including the underlying costs of BT Sport, separately detailed.
- The allocation of costs between different products should from the outset be as prescribed by Ofcom – this is particularly important for backhaul costs and BT Sport costs.

3.7 An important assumption used to derive costs will be cost allocation. BT cannot and should not be trusted to allocate costs in a proper way. BT have shown in their preparation of the Regulatory Financial Statements (RFS) that they game cost allocation in order to meet their own self-serving commercial objectives – in the case of the RFS, by inflating the reported costs of regulated products to increase BT's profits. Some of the more egregious examples of their self-serving behaviour include:

- Double recovery of the costs of excess construction – once in the excess construction charge and again in leased line rental charges.
- Shifting costs between recently set charge controls and soon-to-be-set charge controls to allow the same cost to be counted twice.
- Allocating the costs of deafness claims to regulated products when Ofcom had previously made clear that such costs should not be included.
- Allocating central HR costs on the basis of assets, an approach which is plainly non-causal and loads excessive cost onto regulated products.
- Changing the method of cost allocation during the lifetime of a product in order to double-recover some costs (compared to keeping the method constant).

3.8 Therefore, Ofcom must from the outset be highly prescriptive about how costs are allocated to VULA products, or BT will game the allocation to reduce the retailing costs to make it appear as though it is not margin squeezing. In the Regulatory

Financial Reporting Review, Ofcom is proposing to take a prescriptive approach for the preparation of the RFS and it should be similarly prescriptive in the case of VULA margin reporting. The costs whose allocations will be most critical to prescribe include:

- BT Sports costs – we think the allocation should reflect both which customers can receive BT Sports as part of their package and whether they can receive BT Sport on their TV (or solely via an app).
- Backhaul costs (and Internet peering) – we think the allocation should be in proportion to the usage level (e.g. peak Mbps or Gb per month) of different broadband packages.
- Central management/overhead costs and how they are allocated across BT Group and to different products.

3.9 Ofcom will also need to specify how wholesale costs are taken into account. We see a number of assumptions that should be adopted:

- For copper access MPF should be assumed as the core access product.
- The GEA product assumed (e.g. 80:20 or 40:10) should match the retail product in question.
- Total backhaul costs should be based on the use of Ethernet (i.e. EBD circuits) since these are the products that entrants use for backhaul.

3.10 A final area that will be important to prescribe is the 'valuation' approach e.g. over what specific period should upfront SAC costs be amortised[10]. The period could be based on the long-term churn level for customers taking that product. It appears that since Ofcom has requested that BT provide BT's churn figures then it may intend using BT's churn figures. However, we would caution that the churn figure used for assessing the margin is likely to be above that of BT. Given BT is margin squeezing currently their churn rate will be less than would be expected in a properly competitive market; BT's own churn figure should therefore be adjusted upwards for use in the margin squeeze test.

3.11 It is important to note that the 'costs' that BT will be reporting will be a mixture of its own incurred costs and a number of adjustments that are necessary for the purposes of checking for margin squeeze. Therefore, the costs presented in the report will not reconcile with BT's costs shown in its RFS or statutory accounts.

3.3 Integrity of costs

3.12 It will obviously be key that the costs (before adjustments) that BT reports are accurate and that there is a high level of accuracy from the very first report. The reporting will be of limited use if it takes several months for the costs to be corrected to present a proper picture or if BT presents data based on its judgements and estimates (that are likely to be biased to favour its commercial interests). The

[10] Or equivalently over what period should payback be calculated.

integrity of this VULA margin report is arguably more important that the RFS since the RFS can be corrected before they are used to set charge controls (as they frequently are).

3.13 Therefore we suggest a number of steps Ofcom should include in the margin squeeze reporting obligation to aid integrity:

- be highly prescriptive from the outset as to how costs and revenues should be derived;
- the report should be audited by an external party;
- the report should be signed off by a senior Director (as is proposed to be required for the RFS);
- there should be a very high degree of transparency. We accept that some of the cost figures themselves cannot be fully disclosed. However, the allocation bases and other preparation rules can be disclosed. Ofcom should consider what can be published of the resulting report and only redact information where strictly necessary.

3.4 Timing of reporting

3.14 Ofcom has proposed 6 monthly reporting. We agree with this in the medium term, though in the initial stages we think an additional report produced after 3 months would be warranted so that any teething problems can be identified and resolved quickly (i.e. there would be a report at 0 months, 3 months, 6, 12, 18 etc).

3.15 Ofcom also needs to dictate when the report should be provided. It cannot be as slow as the RFS (4 months after year end) particularly since the value of the report diminishes significantly the later it is provided. We suggest 4-6 weeks after the period end is appropriate.

3.16 Ofcom has suggested that the first report will be sought from BT 'shortly after the publication' of the statement on the VULA margin[11]. We fully agree. By the point at which this statement is published the market review period will already be several months old and therefore it is wholly appropriate that margin squeeze is tested immediately. We believe that BT can and should prepare for the reporting obligation in advance of the final statement[12] so that it can comply with the obligation quickly. We believe that BT should provide the first report within a matter of weeks of the statement.

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[11] We understand this is not the statement on the FAMR Market Reviews but rather the statement on guidance for the VULA margin which will follow.

[12] Since there may be a consultation on the implementation of the reporting obligation and/or the basis for deriving costs then BT will have foresight of what is likely to be included in the reporting obligation. It is also relevant in this respect that BT should already be gathering and analyzing the data required to assess margin squeeze (as Ofcom noted in its consultation at §4.5).

3.5 Other issues

3.17 Ofcom should consider what deterrents would be appropriate in the case where BT breaches its reporting obligation. The reporting obligation will be an important tool in detecting margin squeeze, and if BT is able to sidestep the obligation by inaccurate or late reporting (say) then its value will be significantly diminished. Therefore, it is important that BT understands clearly that the consequences for non-compliance will be serious.

3.18 In this context it is worthwhile noting that BT has currently breached (or come very close to breaching) other reporting obligations recently. For example:

- In the 2012 LLU Charge Control BT made s.135 submissions to Ofcom regarding forecasts for copper recovery income that were plainly inconsistent with internal documents that came to light in the subsequent appeal;
- in the 2012 LLU Charge Control appeal BT did not provide fault rate data that was explicitly requested of it – this came to light since it used the 'missing' data elsewhere. Once it had been found out BT provided the data to Ofcom;
- Even though BT has an obligation to report in the RFS on the revenues and costs of SFI and TRC it is apparent that their reporting is extremely poor and unreliable to the degree to which Ofcom does not feel it can rely on either the revenue or costs presented and has instead chosen to use another source for the data.[13]

[13] See Ofcom (2014), *Fixed access market reviews: Further consultation on notification periods, compliance with requirements on the VULA margin, and approach to pricing for TRCs and SFIs* 16 January at §5.64 *et seq*.