SKY'S RESPONSE TO OFCOM'S CONSULTATION ON ITS 'PROPOSED DIRECTION SPECIFYING THE FAIR AND REASONABLE CHARGE THAT BT MAY APPLY FOR MPF RENTAL PROVIDED AT SML1'

EXECUTIVE SUMMARY

1. Sky welcomes the opportunity to respond to Ofcom's 2017 consultation on its 'Proposed direction specifying the fair and reasonable charge that BT may apply for MPF Rental provided at SML1' ("**2017 MPF SML1 consultation**").

2. Strong regulation of BT's significant market power ("**SMP**") in the wholesale local access ("**WLA**") market, including tight price control of key inputs such as metallic path facility ("**MPF**"), is essential to delivering vibrant competition, more choice and lower prices for consumers.

3. However, as with previous wholesale local access market reviews ("**WLAMRs**"), Ofcom has allowed a gap between the previous charge control (which expired on 31 March 2017) and the implementation of a new one (which is due to start on 1 April 2018) (the "**lacuna period**"). Given BT's ability and incentive to exploit its SMP by setting MPF charges above the appropriate level, lacuna periods risk seriously harming competition and consumers and creating uncertainty for communications providers ("**CPs**") who rely on MPF as a critical wholesale input to their retail communications services.

4. Accordingly, it is incumbent on Ofcom to re-double its efforts to ensure that lacuna periods do not occur in the future. In the event that they do arise, use of Ofcom's direction-making powers to set the relevant price (as proposed in the 2017 MPF SML1 consultation) is fully justified. While it is unfortunate that a lacuna period has arisen here, Ofcom's proposal to direct BT's MPF rental prices in the interim period is a welcome improvement from previous lacuna periods where BT's voluntary pricing commitments – which typically favoured BT at the expense of competition and consumers – prevailed.

5. When making such a direction, Sky considers that there are three important principles which should be applied (but which were not applied in this instance):

   - there should be no gap in Ofcom's setting of BT's charges;
   - Ofcom should provide advanced clarity about how it will control prices over the lacuna period; and
   - interim prices should be based on the best, latest view of BT's costs.

6. With respect to this last principle, Ofcom's proposed interim MPF rental pricing of £84.38 per annum is too high, as no reduction has been made for inappropriate cost attributions previously made by BT. The current proposals do not go far enough, therefore, and BT's charges would be excessive for too long. Instead, the interim MPF rental price should be reduced further to around £80 p.a. to reflect the starting charge adjustments ("**SCAs**") necessary to correct for BT's inappropriate cost attributions. Applying SCAs in this way would be consistent with Ofcom's approach to these same inappropriate cost attributions

in the 2016 leased lines charge control ("**2016 LLCC**") imposed as part of the 2016 Business Connectivity Market Review ("**2016 BCMR**").

7. Finally, but importantly, late market reviews also cause harm because they delay the introduction of important new regulation. In the 2017 WLAMR consultation, Ofcom proposes to introduce a charge control on BT's Generic Ethernet Access ("**GEA**") Fibre-to-the-Cabinet ("**GEA-FTTC**") product.[1] However, the late-running market review means that the implementation of the GEA-FTTC charge control will be delayed by a year and that, for an extended period, GEA-FTTC prices will be higher than necessary and competition will be further distorted and consumers harmed.

8. Therefore, it is also appropriate and justified for Ofcom to direct BT to introduce lower GEA-FTTC charges for its 40/10 Mbps product to around £77.50 p.a. sooner using a similar methodology to the one it proposes for interim MPF prices. Such a move would bring forward essential regulation to the benefit of competition and consumers while ensuring that BT's returns on its FTTC investment remain sufficiently high as to not undermine its investment incentives.

[1] The charge control is proposed for BT's 40/10 Mbps GEA-FTTC product.

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OFCOM MUST CONTINUE TO IMPOSE STRONG REGULATION OF BT'S SMP IN WLA MARKETS

1. Tight control of the price of essential wholesale inputs – including MPF – through charge controls has underpinned wide-scale entry into retail communications markets, leading to increased innovation, more choice and lower prices. Continuing strong regulation of BT's SMP through charge controls in the WLA market is essential to avoid unravelling the significant benefits that have accrued to consumers and businesses.

2. Sky agrees with Ofcom's provisional conclusion in the 2017 WLAMR consultation that, in the absence of a charge control on MPF:

> *"BT would have the ability and incentive to exploit its SMP by pricing at an excessive level. This could cause harm to consumers by inhibiting downstream competition as well as leading to excessive prices for retail services that rely on WLA (including standard and superfast broadband)."* [2]

3. Therefore, it is appropriate for Ofcom to ensure there is a binding regulatory constraint on BT's prices for its SMP services at all times.

LACUNA PERIODS CREATE A SERIOUS RISK OF HARM TO COMPETITION AND CONSUMERS

4. Ofcom is required to carry out its review of the WLA market and make SMP determinations every three years.[3] The charge controls for MPF set by Ofcom in the 2014 Fixed Access Market Review ("**2014 FAMR**") expired on 31 March 2017. Ofcom is only consulting now on new charge controls which will come into force from 1 April 2018, leaving a lacuna period of one year.

5. Given BT's strong incentive to set excessive wholesale charges for MPF, any material gap between charge controls creates a serious risk of harm to competition and consumers, and creates significant uncertainty for CPs – such as Sky – that rely on MPF as a critical wholesale input to their retail communications products.

6. Typically, BT has been allowed to make voluntary pricing commitments to cover pricing until a new charge control commences. In this case, BT made a voluntary commitment that the annual rental charge for MPF[4] would continue to be no more than £87.65 from 1 April 2017 to 31 December 2017.

7. Relying on BT to make voluntary pricing commitments for lacuna periods is wholly unsatisfactory and provides insufficient protection to competition and consumers. This is evident from BT's voluntary pricing during previous lacuna periods, where it has adopted different methodologies to reflect the most advantageous position to it. BT has done this by either: (i) maintaining the level of prices at the end of the expiring charge control period where there was a clear downward costs trend (as is commonly, but not always, the case);

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2 Paragraph 9.9, volume 1, 2017 WLAMR consultation.

3 Section 84A(7)(b) Communications Act 2003.

4 This commitment relates MPF SML2 rental as opposed the MPF SML1 rental (which is the subject of Ofcom's proposed MPF direction).

or (ii) bringing forward price increases where it appeared that there would be a higher charge control in the next charge control period. For example:

- During the lacuna period between 2011 and 2012, which lasted more than a year, BT committed not to increase MPF rental charges above £91.50 p.a.. This was beneficial to BT because, had the charge control started on time, the implied price for MPF would have been £87.85. Even by reference to the earlier proposed base case prices for MPF during Ofcom's March 2011 consultation on "Charge control review for LLU and WLR services", the price would have been £90.[5] On this basis, BT's voluntary pricing was between £1.50 and £3.65 too high. Taking into account similar effects for Shared MPF ("**SMPF**") and Wholesale Line Rental ("**WLR**") the total value of the gain to BT from the lacuna period potentially exceeded £30m; and

- During the lacuna period from April 2014, BT proposed increasing its annual rental charges to £88.81 for MPF and to £94.29 for WLR. These charges were at the upper end of the range proposed in Ofcom's December 2013 fixed access market review consultation, not the base prices proposed by Ofcom. Although BT committed to refund the difference between its charges and any subsequent charge control, BT's approach was clearly designed to bring forward any anticipated price increases (in direct contrast to its approach when there were anticipated price reductions) and charge the maximum amount possible.

8. These examples show clearly that BT has been able to exploit its SMP during lacuna periods by offering voluntary pricing commitments that are most profitable to BT Group and least beneficial to competition and consumers.

9. With this in mind, Sky is concerned that – across a wide range of regulated markets – lacuna periods have been increasing in both frequency and length. Not only does this provide BT with the opportunity to exploit its SMP by setting excessive wholesale prices, but it also incentivises BT to delay future market reviews in order to benefit from the absence of back-to-back regulation – for instance, by responding slowly or partially to Ofcom's information requests.

10. Sky has long argued that this approach to lacuna periods is not in consumers' interests and that Ofcom should use its powers to ensure that prices are not excessive.[6] Therefore, we welcome Ofcom's acknowledgement that:

> *"… given the timing of the expiry of the present charge controls and the significance of this service to telecoms providers, and the importance of these services to downstream competition, we are concerned that if we do not take steps now using our regulatory powers, there will be an extended period of delay and uncertainty for industry as to the level of the fair and reasonable charge for MPF. This uncertainty may involve regulatory disputes to resolve."*[7]

11. Further, notwithstanding Ofcom's publication of BT's current voluntary commitment, it subsequently stated that:[8]

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5 Figure 1.1, Ofcom, 'Charge control review for LLU and WLR services' consultation, 31 March 2011.

6 See, for example, section 9 of Sky's response to Ofcom's consultation on 'Fixed access market reviews: Approach to setting LLU and WLR Charge Controls', 11 July 2013.

7 Paragraph 1.18, 2017 MPF SML1 consultation.

8 See Ofcom's update on 1 November 2016, available here: https://www.ofcom.org.uk/phones-telecoms-and-internet/information-for-industry/telecoms-competition-regulation/narrowband-broadband-fixed.

- it had taken no decision in relation to BT's pricing of LLU (or other) services in the lacuna period;

- it would consider the appropriateness of exercising its regulatory powers to set charges during the lacuna period at the same time as consulting on proposals for the forward looking period; and

- it would consult with stakeholders on its proposed approach and would consider any representations received before taking any decision on the exercise or otherwise of those powers.

12. Clearly, the best solution to this issue is for Ofcom to ensure that lacuna periods do not arise in the first place and, as such, it is important that Ofcom better prioritises its resources to conduct market reviews on time in order to avoid harm to competition and consumers.

IF OFCOM IS UNABLE TO COMPLETE MARKET REVIEWS ON TIME, IT MUST SET INTERIM PRICES

13. Where Ofcom is unable to complete market reviews on time, it is entirely appropriate and preferable for it to use its powers to set interim prices – as it now proposes.

14. When doing so, there are three important principles that Ofcom should follow:

    (a) There should be no gap in Ofcom's setting of BT's prices. The current charge controls on MPF expired on 31 March 2017 and – at best – Ofcom's proposed pricing direction will not take effect until late-May or early-June 2017;

    (b) Ofcom should be clear in advance about how it intends to control prices during a lacuna period. As Ofcom recognises *"… it is important for there to be greater legal certainty and transparency for telecoms providers as to the level of the charges that will apply in the period prior to the introduction of the new charge controls"*[9]; and

    (c) Interim prices should be based on Ofcom's best, latest view of costs. (See paragraphs 17 to 23 below).

15. Overall, Sky welcomes Ofcom's proposal to issue a direction to BT specifying the fair and reasonable charge for MPF. While we recognise that this is a new approach from Ofcom, we recommend that should lacuna periods arise at future market reviews, Ofcom should ensure that these three principles are always met.

16. Sky also considers that, in light of the evidence, BT's current voluntary pricing, which has been in place since 1 April 2017 and exceeds Ofcom's proposed interim price, is unlikely to be fair and reasonable, contrary to its network access obligations.

THE MPF PRICE REDUCTIONS IN OFCOM'S PROPOSED DIRECTION ARE TOO SMALL

17. While it is appropriate for Ofcom to direct BT to lower its MPF SML1 rental price from the current £85.29 p.a., in Sky's view it should be set closer to £80 p.a. as opposed to the £84.38 proposed. This is because an additional one-off reduction in starting charges (a

[9] Paragraph 1.19, 2017 MPF SML1 consultation.

SCA) is necessary to correct for BT's inappropriate cost attributions between regulated and unregulated markets – which Ofcom has found are not causal and objective.[10] Adjusting for these straightaway is fully justified and would be consistent with Ofcom's approach to the 2016 LLCC imposed in the 2016 BCMR. Failure to do so would result in considerable consumer harm and incentivise BT to continue to attempt inappropriate cost attributions to regulated services.

18. As part of its Cost Attribution Review in November 2015 ("**November 2015 CAR**"), Ofcom concluded that certain BT cost allocations – for example, those relating to general overheads – were not objective and causal. It found that, as a result, BT had allocated £255m[11] in operating costs and £157m[12] in mean capital employed ("**MCE**") to regulated markets – including business connectivity and fixed access (including wholesale fixed analogue exchange lines and WLA) markets – which instead should be appropriately allocated to unregulated markets. With respect to fixed access markets, this meant that reported costs were over 8% too high.[13] As a result of these findings, Ofcom considered whether it would be appropriate for it to implement SCAs in the 2016 LLCC.

19. Typically when setting charge controls, Ofcom aims to incentivise BT to be more efficient by using a glide-path to reduce (or increase) regulated charges to forecast costs by the end of the charge control period. This can promote dynamic and productive efficiency because, if BT reduces its costs below the forecast, it can keep the additional profits and will, therefore, be incentivised to drive efficiency during subsequent charge controls. While there can be some allocative inefficiency because prices are above costs for longer, it is considered that this can be outweighed by the dynamic and productive efficiency gains.

20. However, in the 2016 BCMR, Ofcom also imposed SCAs to the 2016 LLCC to ensure that costs allocated inappropriately to business connectivity markets were not recovered from regulated charges.[14] Ofcom's clear rationale was that it would be incorrect to impose a charge control with only a glide-path in this case because it would result in prices being significantly above costs for reasons other than efficiency or volume growth.[15] Further, Ofcom considered that if it did not impose a SCA, BT would be rewarded for its subjective and non-causal cost attributions and would be incentivised to make inappropriate cost attributions in the future.[16]

21. These same principles apply equally when considering the new WLA charge controls and whether to issue a direction setting MPF charges in the interim; otherwise MPF prices will be significantly above costs solely because of BT's inappropriate and incorrect cost attributions. Given WLA costs are likely to have been overstated by more than 8%, the

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10 See Ofcom's analysis of this problem at paragraphs 6.130-6.136, 'Business Connectivity Market Review: Leased lines charge controls and dark fibre pricing', consultation, 12 June 2015 ("**June 2015 LLCC consultation**"); paragraphs 8.34-8.39, 'Review of BT's cost attribution methodologies', consultation, 12 June 2015; and section 3.3, Frontier Economics, 'The profitability of BT's regulated services: a report for Vodafone', 28 November 2016 ("**Frontier Report**").

11 Table 1.3, November 2015 CAR, available here: https://www.ofcom.org.uk/__data/assets/pdf_file/0025/84814/bt_cost_attribution_review_second_consultation.pdf.

12 Table 1.4, November 2015 CAR.

13 For fixed access markets, operating costs were £177m and MCE were £93m above the appropriate level out of total reported operating costs and MCE of £2,336m and £9,015m respectively. (See Tables 1.3, 14 and A5.2, November 2015 CAR).

14 See, for example, paragraph 1.11 June 2015 LLCC consultation.

15 See, for example, paragraph 4.79, June 2015 LLCC consultation.

16 See, for example, paragraph 4.111, June 2015 LLCC consultation.

current MPF rental price (£85.29) could be nearly £7 higher than it should be (i.e. c.£79.50). This equates to c.£60m in excess earnings by BT over the course of 2016/17.

22. Accordingly, it is clear that Ofcom's proposed interim price (£84.38) should be reduced further. Sky appreciates that in setting the charge control, Ofcom may wish to account for BT's future efficiency incentives and a reasonable margin of error, and avoid charges that rise too steeply in subsequent years.

23. However, weighing these considerations together, Sky considers that an appropriate interim MPF SML1 rental price reduction would be in the region of £4-6, the mid-point of which would result in an interim price of close to £80. While this interim price level would result in minor MPF price increases in the outer years of the charge control, this would be far outweighed by the benefits of aligning prices more closely with the appropriate level of costs sooner.

OFCOM MUST APPLY ITS DIRECTION MAKING POWER TO REDUCE THE PRICE OF GEA-FTTC SOONER

24. Late market reviews can also cause harm because they delay the introduction of important new regulation, including imposing charge controls on SMP services for the first time.

25. Here, the delay in conducting the WLAMR will, absent further interim measures, cause a delay in introducing Ofcom's new proposed charge control on GEA-FTTC. Given the importance of GEA to downstream competition, the late introduction of the GEA-FTTC charge control could cause even greater consumer harm than that caused by BT's voluntary pricing commitments for MPF rental.[17] Accordingly, it is also appropriate and justified for Ofcom to also impose a direction on BT to reduce its GEA-FTTC (40/10 Mbps) charges to around £77.50 p.a. in the interim.

26. Ofcom recognises in the 2017 WLAMR consultation that BT is making high returns on its Virtual Unbundled Local Access ("**VULA**") services and that, absent regulation, those returns will continue to grow.[18] In addition, Ofcom considers that BT has had a fair opportunity to make a return on its original FTTC investment and that the 'fair bet' in relation to some VULA services is now over.[19] Ofcom acknowledges that BT's current pricing flexibility is likely to give rise to a risk of excessive pricing by BT and to lead to higher prices for consumers.[20] Rightly, therefore, Ofcom proposes to introduce a charge control for certain GEA services.

27. However, the introduction of a GEA-FTTC charge control in April 2018 is an extremely late intervention, given the current pricing flexibility from which BT continues to benefit.[21] Such a delay in the introduction of important new regulation will prolong the distortion to competition and continue to cause consumer harm as a result of high GEA charges.

17 For further information, please see [redacted].

18 Paragraphs 8.29-8.32, volume 1, 2017 WLAMR consultation.

19 Paragraph 8.23, volume 1, 2017 WLAMR consultation.

20 Paragraph 8.24, volume 1, 2017 WLAMR consultation.

21 At paragraph 8.23, volume 1, 2017 WLAMR consultation Ofcom stated that *"… our judgment at this stage is that BT has had a fair opportunity to make a return on its original risky investment and a charge control would be consistent with the 'fair bet'. We therefore believe this is no longer relevant to our price regulation of superfast broadband …"*

28. Although Ofcom's proposed approach of requiring a steep reduction in the GEA 40/10 Mbps rental charge from the current £88.80 p.a. to £66.28 p.a. at the start of the charge control goes some way to mitigating this (because it would set the GEA charge for 2018/19 at the level it would have been had the charge control commenced on 1 April 2017), there is still substantial consumer welfare loss from prices remaining too high up until 1 April 2018. If the GEA charge control had started on 1 April 2017, it is likely that the price for this year would have been in the region of £77.50 (halfway between the current price and the proposed price from April 2018).[22] This implies that BT could earn nearly £100m in additional GEA profits than would otherwise have been the case if the charge control had started on time.[23]

29. Therefore, Ofcom should consider whether it is appropriate to ensure that BT's VULA pricing is fair and reasonable by directing BT to introduce lower GEA charges sooner.

30. Moreover, reducing GEA prices now would not undermine the 'fair bet' because BT's return on its risky FTTC investment would still be sufficiently high to preserve its incentives to take future risks.[24] Such a move would bring forward essential regulation to the benefit of competition and consumers and establish a useful precedent to safeguard against BT causing delay to market reviews in the future.

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22 Figure 2.3, volume 2, 2017 WLAMR consultation.

23 This assumes that the rental prices of c.8 million GEA lines are effectively c.£11 too high – this includes the prices for 40/2 Mbps and 55/10 Mbps GEA services which, while not strictly subject to the proposed charge control, could be anticipated to fall by a similar amount to the price reductions for the 40/10 Mbps GEA service.

24 We note that Ofcom estimates that the internal rate of return ("**IRR**") on BT's FTTC investment only reduces from 11.8% to 11.6% if the GEA 40/10 Mbps rental charge is brought in line with costs in 2018/19 as opposed to in 2019/20 as proposed (see paragraph 2.94, volume 2, 2017 WLAMR consultation). Given this estimate, a similar magnitude of *de minimis* impact on BT's IRR could also be expected if Ofcom directed GEA 40/10 Mbps rental charges to be reduced to £77.50 in the interim period up to April 2018. Therefore, such an approach would not materially alter BT's relatively high returns, the fair bet and its future investment incentives.