**Ofcom**

# Response to the Fixed-Access Market Review: WLA-related issues

**TalkTalk Group submission**

***Non-Confidential version***

**25 September 2013**

# 1 Introduction

1.1 This paper sets out TalkTalk Telecom Group plc's ('**TalkTalk**') response to the elements of Ofcom's Fixed Access Market Review ('**FAMR**') dealing with wholesale local access ('**WLA**').[1] We agree with Ofcom's core proposal for the imposition of margin squeeze protection in the superfast broadband ('**SFBB**') market.

1.2 This main document focuses on the key points which TalkTalk considers relevant for Ofcom's consideration. More detailed points are set out in the series of annexes attached to this document, which also form an integral part of TalkTalk's overall submission[2].

1.3 TalkTalk's core points as set out in this response are the following:

- without regulatory action, BT is likely to margin squeeze on SFBB and thereby harm consumers;
- decisive margin squeeze protection is more appropriate at present than wholesale price regulation;
- a margin squeeze protection test should be undertaken in advance of products being launched;
- this margin squeeze test should be applied to bundles, with an appropriate cost allocation for BT Sport included; and,
- it will be important for Ofcom to set out a clear methodology for determining key margin squeeze test parameters such as customer lifetime and bandwidth costs.

1.4 If Ofcom is unable to impose a margin squeeze protection regime that will be effective in practice then it should (as a second best) impose wholesale price caps. Wholesale price caps will be more pro-competitive than poorly designed margin squeeze protection which would have limited practical effect.

# 2 Market definition and SMP analysis

2.1 Overall, we have few concerns with the approach adopted by Ofcom to market definition and SMP analysis. Where we do have such concerns, we do not consider

[1] This response does not cover responses relating to WFAEL, ISDN30, or ISDN2, all of which are also dealt with in Ofcom's FAMR consultation ('**the Consultation**') – Ofcom (2013), *Fixed access market reviews: wholesale local access, wholesale fixed analogue exchange lines, ISDN2 and ISDN30*, 3rd July 2013. There is also no coverage of Ofcom's conclusions on market definition or remedies in Kingston-upon-Hull provided in this paper. TalkTalk is not active in Hull, and has no plans to be active; as such, we have no comments regarding developments in that separate market.

[2] This response, including its annexes, should be considered to supersede all of the elements contained within TalkTalk's earlier responses dated 8 May 2013 and 13 May 2013, where it considers issues also dealt with in those prior responses. Where this response does not cover a particular topic which was assessed in earlier responses, those responses should be considered to stand.

that amending for them would make a material difference to the outcomes of Ofcom's analysis. We therefore believe that Ofcom has reached the correct conclusion on the issue of SMP– it has correctly determined that BT holds SMP in the WLA market across the UK (excluding Hull). TalkTalk believes that the evidence supporting this conclusion is overwhelming, and that there is no other conclusion which could rationally be reached by Ofcom.

2.2 TalkTalk's detailed views on market definition and SMP analysis are set out in detail at Annex 1 to this document.

# 3 BT's incentives to engage in anti-competitive conduct

3.1 We consider that BT's incentives to engage in anti-competitive conduct are very strong, and that, in the absence of decisive *ex ante* regulation to prevent or deter such conduct, BT will act on its profit incentives and attempt to exclude downstream rivals from the SFBB market. Our detailed analysis of this is set out in Annex 2.

3.2 The incentives for BT to engage in exclusionary behaviour are particularly high in the SFBB market at present. The SFBB market is currently in a customer acquisition phase, after which TalkTalk expects switching barriers to make it much more difficult for ISPs to substantially increase their market share. As such, through anti-competitive behaviour BT will be able to lock in a strong – or even dominant – position in the downstream market by excluding its rivals during this phase.

3.3 TalkTalk considers that of all the potential anti-competitive strategies which could be adopted by BT, margin squeezing is particularly likely. Margin squeezing is generally highly effective at excluding downstream competitors and unlike predatory pricing (i.e. pricing below cost at retail level) which incurs short-term losses that need to be recouped from long-term profits, there are few potential losses for BT which might reduce the profitability of a margin squeezing. We explain our thinking below.

3.4 Margin squeezing will enable BT Retail to increase its market share in SFBB products, while at the same time leading to supernormal profits for BT Openreach from customers remaining with downstream competitors. There are therefore two unambiguous short term effects increasing profits; in both cases, TalkTalk considers that the effect may be substantial.

3.5 Moreover, BT can make major long-term gains from engaging in a margin squeeze on SFBB products. These gains arise from:

- the potential exit of downstream rivals from the SFBB market, enhancing BT's market power;
- BT obtaining a reputation for eliminating downstream rivals, deterring entrants;
- the lock-in of acquired customers due to switching costs (allowing super-normal profits in the longer term); and,

- the potential to leverage market power from the retail SFBB market into other markets.

3.6 Set against the substantial short-term and longer-term gains from squeezing, the costs of such action are relatively low. Although engaging in a margin squeeze might lower the number of SFBB customers on the (upstream) Openreach network, as other downstream firms offer less attractive SFBB products, or promote those products less aggressively, in practice this effect is likely to be relatively small, as there will remain actively-promoted SFBB products on the BT Openreach network (the BT Retail products). As such, the costs of margin squeezing are likely to be very small and considerably outweighed by the benefits; there is cheap exclusion.

3.7 We contend that BT is currently acting on these incentives and is margin squeezing in practice – this is consistent with Ofcom's view set out on 1st May 2013 that it had a 'reasonable suspicion' that BT has been engaging in a margin squeeze in the SFBB market. In our view, BT Retail's very high market share in SFBB (87% of Openreach connections) is *prima facie* evidence that there is an ongoing margin squeeze particularly given that their share of copper connections is less than 40%. We do not think that there is any plausible explanation for such a high market share other than BT margin squeezing:

- This high market share could result from much greater efficiency of BT Retail compared to its competitors. However, if that were the case, BT's market share would also be high in copper connections, given the substantial commonality of costs between the two businesses.
- Alternatively, as Ofcom have suggested (at paragraphs 11.301 to 11.304), the high share could be due to a lack of inclination on the part of non-BT ISPs to sell SFBB, rather than an ongoing margin squeeze. We do not think this is plausible. SFBB is a natural product for ISPs already selling SBB; without SFBB ISPs will struggle to grow their overall consumer broadband business. Further, the widespread opinion among ISPs is that the market will over time shift towards SFBB. In such a situation it would be logical for ISPs to acquire SFBB customers in the growth phase given the high costs of acquiring customers from other operators once those customers have already settled on an SFBB supplier. In our view, competitors would aggressively promote SFBB if they were not currently being subjected to a severe margin squeeze by BT.

3.8 Regulatory intervention is therefore essential to prevent and deter BT from setting wholesale and retail prices in a manner that margin squeezes its downstream rivals. Regulation will need to either <u>prevent</u> a margin squeeze from taking place in the first place (by, for instance, Ofcom pre-approving BT's pricing of SFBB products) or provide for substantial <u>deterrence</u> through punishment for margin squeezing (or both). In particular, regulation must go beyond simply stopping BT from margin squeeze on a particular product sometime after it has begun (as happens, for example, under the Competition Act). This *ex post* type of intervention is highly unlikely to provide sufficient disincentive from margin squeezing, particularly during the ongoing customer acquisition phase – even if BT were required to repay full damages to harmed competitors (which is far from certain) it will still be profitable

for them to margin squeeze[3]. Furthermore, an *ex post* system does not provide the certainty for competitor ISPs to make the substantial investments in customer acquisition that are involved in serving SFBB customers.

3.9 We believe that regulation must prevent the possibility of margin squeeze (or at least make material margin squeezes extremely unlikely). This would be most consistent with the underlying aim of the *ex ante* regime, which is to provide regulatory certainty and proactively promote competition in markets, rather than simply preventing abuse of market power.

3.10 As Ofcom Chief Executive Ed Richards has previously said:[4]

> *What is the most effective way of dealing with competition concerns in the communications sector? We think the answer is that it depends on the specific concern.* ***Take the case of dealing with enduring bottlenecks, for example wholesale inputs in fixed telecom markets.*** *I think most regulators in Europe and globally would agree* ***ex ante regulation seems a more effective solution than ex post****.* [Emphasis added]

3.11 For the avoidance of doubt, we do not consider than the Competition Act would be sufficient to avoid margin squeezes.[5] Such protection would lack the ability to actively promote competition, would take a considerable length of time to come into effect, and would impose resource requirements on Ofcom. Furthermore, BT's current behaviour in margin squeezing TalkTalk clearly demonstrates that the Competition Act is an inadequate deterrent to BT abusing its market power.

# 4 Wholesale price cap or margin squeeze protection?

4.1 In theory, if Ofcom wishes to prevent margin squeezes, it could try to do so either by putting in a place a wholesale price cap, or by imposing margin squeeze protection. Either of these could in principle prevent BT from abusing its upstream market power, although the manner in which they would do so, and the manner in which the regulatory intervention would occur, differs substantially.

4.2 We agree with Ofcom that at this stage in the market's development, as set out in Annex 3, *ex ante* margin squeeze protection is most likely to further consumers' interests. Our key reasons for this view include:

- potential difficulties in determining an appropriate cost and so wholesale price cap, due to uncertainties over the extent and cost of remaining SFBB roll-out and take-up in covered areas. While upstream network costs (needed for wholesale price regulation) are relatively difficult to determine, in contrast downstream retail costs (needed for margin squeeze protection) are well-understood;

[3] Damages can only cover harm to ISPs and will in general be unable to effectively remove the profit to BT from restricting competition

[4] http://media.ofcom.org.uk/2010/07/13/competition-law-and-the-communications-sector/

[5] That is, a situation where there is neither *ex ante* wholesale price cap regulation nor *ex ante* margin squeeze protection.

- the possible negative impact wholesale price cap regulation could have on BT's investment incentives (though this is limited since almost all of BT's NGA investment has either been made or been committed);
- margin squeeze protection regulation can deal with both predatory retail prices and excessive wholesale prices (whereas wholesale price cap regulation can only directly prevent excessive wholesale prices). Though under wholesale price caps margin squeezes could be deterred using the Competition Act, as we explained above this is inferior to regulation since it cannot allow the margin to be sufficiently high to reflect competitors' costs and is a less effective deterrent;
- in particular, in the case where BT is penetration pricing in order to build scale on the network, a margin squeeze test can ensure that this is done in a pro-competitive manner whereas a wholesale price cap cannot do so.

4.3 If Ofcom is unable to put in place reasonably quickly an appropriately calibrated and enforced margin squeeze test, in line with the suggestions we set out in section 5 of this paper, then we consider that wholesale price cap regulation should be put in place instead. Wholesale price regulation would be better than either no *ex ante* regulation, or an inadequate and ineffective margin squeeze protection system. However, our strong preference remains the introduction of an effective margin squeeze protection system which deters or prevents BT from margin squeezing. We think an effective margin squeeze protection system is highly achievable in the current review.

4.4 Though margin squeeze protection is most appropriate for this review period, there could be a transition towards wholesale price cap regulation for the following or subsequent review periods.

# 5 Approach to margin squeeze regulation

5.1 The design of and approach to margin squeeze protection regulation will be critical in preventing margin squeeze and harm to consumers in practice. We have provided Ofcom with a considerable amount of detail regarding our views on this topic, which are further set out at annexes 4 and 5 to the current document.

5.2 The primary purpose of margin squeeze protection regulation is that it is effective in both preventing and deterring any material margin squeeze from occurring. An effective system should be:

- able to be effective immediately on product launch by BT;
- robust to attempts at gaming by BT;
- flexible, in that it is able to deal with all products on the market;
- accurate, in that it generates few false positives or false negatives;
- adaptable to changing market circumstances; and,
- include sufficient penalties to deter non-compliance and gaming.

5.3 In addition we believe that there are a number of other criteria which an ideal system should display:

- transparent and predictable by all industry participants to encourage investment in both network assets and customer acquisition;
- does not unduly delay launch of new retail products or unduly restrict BT's ability to innovate at the retail level;
- efficient, in that it minimises the total administrative costs to all parties (particularly Ofcom).

5.4 We have assessed Ofcom's Options 1, 2 and 3 against these criteria. Whilst these Options have certain attractions we do not consider that they will be effective in meeting Ofcom's aims. Accordingly, we have also devised a different system of margin squeeze regulation which draws on elements of Ofcom's options but also includes the testing of specific products prior to launch. This testing will be done by BT (as part of its normal governance procedures) but according to Ofcom's determined methodology. We consider that this system will be more effective at preventing margin squeeze and is practically implementable.

5.5 We have also reviewed the approach to margin squeeze protection adopted in other EU Member States, as set out in Annex 6. TalkTalk's proposed system is in line with the regulatory approach in other countries, and is particularly close to the system adopted by Comreg in Ireland (though imposes fewer demands on Ofcom's resources). We therefore believe that there is strong evidence that our system would prove workable in practice.

## 5.1 Ofcom's current proposal

5.6 Ofcom's main current proposal for the implementation of margin squeeze protection is set out at paragraphs 11.373 to 11.386 and is termed 'Option 1'. The key elements of this proposal are as follows:

- Ofcom would provide guidance on how it might test for margin squeeze;
- if downstream competitors believed themselves to be subject to a margin squeeze, they would submit a dispute to Ofcom asking Ofcom to resolve the alleged margin squeeze;
- Ofcom would then seek to resolve the dispute under its dispute resolution powers.

5.7 We consider that this proposal is not likely to be sufficiently effective in preventing BT engaging in a margin squeeze against downstream retail competitors. In particular:

- Even without gaming, Ofcom's proposed system will be unlikely to lead to dispute determinations which are quick enough to avoid margin squeezes continuing for long periods. Once a product is launched, there would be a need to negotiate commercially with BT and only after that negotiation was

unsuccessful would a CP be able to submit a dispute to Ofcom. The dispute would then take around four months to resolve (in unexceptional cases). As such, there is likely to be a margin squeeze persisting for at least five months. BT would be willing to take the risk of initially margin squeezing, given the benefits of doing so. In theory Ofcom could impose fines to incentivise compliance. However, due to the lack of predictability of this system for BT (see below), we believe that it may be difficult for Ofcom to impose a sufficiently large fine on BT to incentivise compliance;

- BT will be able to game the system, significantly reducing the effectiveness of the system of margin squeeze protection. For instance, BT could continually modify its products, or withdraw them and launch new products, so that Ofcom only makes determinations about products which are no longer offered to new customers. This is particularly a problem since the product lifecycle for SFBB retail products is very short– BT has already changed the headline prices and bundled elements of all of its SFBB products several times this year, even leaving aside short term discounting;
- Given the absence of a published margin squeeze model and clear detailed assumptions in advance of a dispute being brought, we believe that this system is not as predictable and transparent as possible;

5.8 These are significant issues, which are likely to mean that BT will be able to continue to margin squeeze. In particular, if products are not tested for margin squeeze until after the product has been launched, then the margin squeeze protection regime becomes little more than an application of the Competition Act (but with lesser sanctions).

5.9 There may be a perceived benefit of an *ex post* approach (compared to one where margins are tested before launch) that less work will be required by Ofcom. However, we consider that in practice a complaints-based post launch test approach will absorb more of Ofcom's time and resources that the approach suggested by TalkTalk. We explain why this is the case below.

5.10 Overall, therefore, we believe that Ofcom's current proposal will be ineffective at preventing margin squeezes whilst absorbing large amounts of Ofcom resource.

## 5.2 Ofcom's alternative proposals

5.11 Ofcom also sets out two alternative proposals in the Consultation (denoted Option 2 and Option 3).

- Option 2 would remove the requirement for a dispute to be brought by a third party following a product launch or product price change. Rather, within three months of a product launch, Ofcom would on its own initiative begin an investigation into whether the product generated a margin squeeze, with that investigation taking up to four months. Under this approach, Ofcom would construct and maintain a margin squeeze model which would enable it to undertake investigations. It would then reach a determination on whether the

product was in compliance with BT's margin squeeze obligations, and take action accordingly.

- Option 3 would require Ofcom to develop a margin squeeze model in advance and set a single required margin for SFBB products. This margin would be fixed for the whole regulatory period.

5.12 The main advantage of Option 2 over Option 1 is the creation and maintenance of a margin squeeze model which could in principle be available to all parties. This should significantly enhance the predictability and transparency of the regulatory process. It would also remove the requirement to engage in commercial negotiation with BT, which would eliminate any concerns regarding the compatibility of this approach with the Competition Act.

5.13 However, Option 2 suffers from even greater problems of timeliness and potential regulatory gaming than Option 1. The seven month timeline (3 months for the investigation to begin and then 4 months for a finding to be reached) for a completed investigation of whether a product passes a margin squeeze test is sufficiently long to largely to remove the benefits of this form of margin squeeze protection, as by changing its products, BT will be able to continue to engage in margin squeezing almost untroubled.

5.14 As such, although there are aspects of Option 2 which are an improvement over Option 1, the overall system appears unlikely to be successful in ensuring that BT does not engage in a margin squeeze.

5.15 Option 3 has a very different set of problems to either of Options 1 or 2. It does not face any issues regarding its timeliness, as by its nature there is no scope to set a price which leads to a margin squeeze pending the outcome of an Ofcom investigation. However, we have significant concerns over the impact on the accuracy of the margin squeeze regime of having a single set margin (whether in percentage or absolute terms) for all products. The required margin will be highly case sensitive and depend on the features and downstream costs of each product. Thus it is unclear how a single model can manage this complexity without leading to 'false positives' or 'false negatives'. Further, BT could add additional features into a product to game the system.

## 5.3 TalkTalk's preferred system

5.16 As can be seen from the above, although the three options in Ofcom's draft proposals have some strengths, we do not believe that in practice they will be effective in preventing margin squeezes from occurring.

5.17 The core missing element of all of the proposals is the testing of an individual specific product (based on its particular features, costs, prices and discounts) which takes place prior to that product being launched to consumers. The current proposals either do not undertake a test until well after the product is launched (Options 1 and 2) or do not test the specific product at all (Option 3).

5.18 A concern about prior testing of specific products might be Ofcom's ability to test quickly enough (while not requiring excessive resources) so that BT's retail product launches are not unduly delayed. We think this can be achieved by developing a model and linked assumptions in advance that can be quickly adapted to a specific product. BT would then conduct the margin squeeze test according to Ofcom's model/assumptions (as part of its existing governance procedures and provide confirmation to Ofcom that it has undertaken the test according to Ofcom's model and that it passed the margin squeeze test.

5.19 The core elements of our proposed system are as follows:

### 1. Prepare generic model/assumptions

5.20 Prior to the system coming into effect, Ofcom will build and consult on a generic but adaptable model of margin squeeze protection (with guidelines on the assumptions used to populate it). Following consultation, the model and supporting assumptions will be finalised, and will then be published to all parties including both BT and downstream competitors.

### 2. BT tests specific product based on Ofcom assumptions

5.21 When BT wishes to launch a new product, or amend an existing product (as a result of different features, increased discounts, or a reduced price) with no commensurate change in wholesale prices, BT would test this product on the basis of the published margin squeeze model as determined by Ofcom. This would involve adapting the generic model to the particular circumstances of the product under test (i.e. downstream costs, retail prices, discounts). If it failed the margin squeeze test on BT's calculation based on the margin squeeze model, BT would be in breach of the margin squeeze condition if it launched that product. If a product failed a test BT would need to redesign it (to change downstream costs) and/ or change its retail prices and/or change relevant Openreach wholesale prices would BT be allowed to launch the product.

### 3. BT file test results with Ofcom and launch

5.22 Following the internal assessment, BT would then provide the populated model, along with a note setting out any assumptions used in populating the model, to Ofcom. Ofcom would not test any of BT's assumptions or input parameters at this stage, and would therefore not take a decision as whether BT's product is compliant at the time of launch. When the populated model has been filed with, and accepted by, Ofcom, BT would then be permitted to launch the product.

### 4. Possible complaints / investigation

5.23 Following launch, if third parties consider that the product is likely to lead to a margin squeeze then they would be able to make a complaint to Ofcom and/or

Ofcom could start an own-initiative investigation. This would be resolved by Ofcom investigating in the same manner as under Ofcom's Option 2. In practice, presuming the preceding stages work effectively, the need for disputes and investigations is likely to be very limited.

5.24 Where Ofcom considered that there had been a material change in circumstances for one or more products (eg, an increase in VAT rates), such that it expects that the previously filed margin squeeze assessment may no longer be appropriate, Ofcom would be able to require BT to resubmit a margin squeeze assessment for specified products within 25 working days.

5.25 This approach has parallels with other parts of the regulatory regime. For example, in the case of charge control baskets BT sets the individual product prices but does so in a way that is in accordance with the overall charge control cap and the formula used to calculate that cap. Similarly, the regulatory financial statements are prepared by BT in accordance with a set of principles that Ofcom has set or agreed with.

5.26 We also believe that it would be appropriate to apply a *de minimis* threshold to price/promotion changes, whereby there would be no need for BT to file a test for a product where the original product test had previously been filed (and passed) and there are changes in introductory discounts or vouchers reducing customer revenue, or increases in acquisition costs, or increased wholesale costs by less than the equivalent of £25 in total from the 'originally filed product'. [6]

5.27 For products which already exist at the time of the margin squeeze protection system being introduced, BT would need to file a test with Ofcom within one month of the system coming into effect. Exceptionally, and only for products which were pre-existing and had not been introduced within the three months prior to the system coming into effect, BT would be permitted to file assessments demonstrating that products failed the margin squeeze test. Where BT products failed this baseline test, their pricing or features would have to be amended, and a revised assessment passing the test filed, within three months of commencement of the margin squeeze protection regime. Following these notifications, the products would be treated in the same way as any other product, and could be investigated by Ofcom on an own-initiative basis, or after a complaint from a third party.

5.28 This model has a number of strengths in terms of fulfilling the criteria set out at paragraphs 5.2 and 5.3 above.

5.29 It will be effective in preventing material margin squeezes. The Ofcom determined margin squeeze test will be applied by BT prior to a product being launched. Whilst this system allows some flexibility to BT as to how it populates the margin squeeze model, we consider that the model/assumptions can be specified to remove most of BT's room for gaming the system. For instance, if BT chose to use an assumption

[6] For example, if average customer lifetime were 48 months, then a wholesale cost increase of 52p or less would be *de minimis*. This would need to be combined with any change in SACs to avoid salami slicing.

that was out of line with the guidelines then it would become visible quite easily (and fines could be imposed). This approach is robust to gaming. In particular, there is no incentive to engage in continual introduction and withdrawal of products, and no incentive to delay assessments being undertaken.

5.30 The scheme should generate few false positives or false negatives, as the model or underlying assumptions can be amended to the particular circumstances of each product and of general market conditions. It therefore avoids the most significant problem of Option 3.

5.31 This scheme is also highly predictable and transparent. All of the market participants will be using the same model to assess adherence to the margin squeeze protection regime, a model which they will have previously been consulted on. This will enable BT to undertake screening in advance of product launch, and downstream competitors to determine whether a new product is likely to breach the margin squeeze conditions or not. Over time this system will become ever more predictable as the tests are applied. We would expect that any uncertainties as to the manner in which different parameters should be determined will quickly be resolved over the course of the first few cases. This should provide all parties with a high degree of regulatory certainty, and further reduce both the administrative costs to BT and Ofcom, and the likelihood of complaints following product launch.

5.32 We think that this system will be less burdensome (particularly for Ofcom) than Ofcom's options 1 or 2. There are two main tasks that are involved in any system of margin testing – the development of a model and assumptions and then adaptation of a model to the specifics of a product. We explain our view below as to why the burden on Ofcom for these tasks will be lower:

- Although hypothetically there might be no disputes or complaints under Ofcom's options (thereby requiring no work at all) this is highly implausible. TalkTalk considers that BT is currently squeezing by £10 or more on its entry level products. Unless these squeezes are fully removed TalkTalk is highly likely to submit disputes/complaints on several products.
- All of the options (Ofcom's 1 or 2 and TalkTalk's suggested option) will involve developing a model/assumptions. In TalkTalk's suggested approach this effort occurs earlier than in Ofcom's options though the same amount of work would be required.
- Under Ofcom's options Ofcom needs to adapt the model to the specifics of different products. Under TalkTalk's approach Ofcom does not need to do this and this work is carried out by BT (except in the case of a post-launch complaint which is relatively unlikely).
- There will be a higher level of controllability and predictability of Ofcom's resource commitment.
- The total resources expended by BT may actually be lower since rather than developing its own view on a margin squeeze test and applying that for each product (as it anyway will be required to do) the test will have been developed by Ofcom.

- Resource usage will also be reduced at competitors compared to Option 1 (as some products which would otherwise be complained about will fail the initial BT check).

5.33 The system is also in line with that operated in other Member States – as such, there is strong evidence that it is workable in practice. For example, amongst the case studies set out in Annex 6 are that:

- Austria has a similar approach of providing a pre-constructed model to the incumbent operator which is used by them to check products prior to launch. In addition, compliance is checked retrospectively to ensure that based on outturn costs there was no squeeze;
- Ireland's regulatory approach for SFBB (and other products) is based on a pre-developed Excel tool for margin squeeze assessment that is used by Eircom. Eircom then notifies Comreg of proposed pricing changes at least 5 working days prior to product launch; a statement of compliance needs to be provided along with this notification. If Comreg does not consider that the product is compliant with the margin squeeze test, it issues an opinion to Eircom. No decision or opinion is provided if Comreg considers that the product is compliant.

5.34 We think that this system of margin squeeze protection should be imposed by means of Ofcom issuing a Direction to BT under the relevant SMP condition, that requires it to complete margin squeeze tests in accordance with Ofcom's model/assumptions, file the results of such tests and only launch products that pass the test. TalkTalk considers that such a system would be entirely proportionate in a situation where, *a priori,* BT have a strong incentive to squeeze, BT is reasonably suspected to be engaging in a margin squeeze on SFBB products at present, and BT has an excessive market share.

5.35 Overall, therefore, this system offers clear advantages over any of Ofcom's Options 1, 2, or 3. We therefore believe that Ofcom should pursue this system, or one similar to it, in preference to any of the approaches set out in the Consultation.

## 5.4 Deterrence of non-compliance

5.36 A well-designed margin squeeze protection system will have built into it deterrents from setting prices which cause a margin squeeze. In the absence of deterrents for non-compliance, BT's optimal strategy will generally be to engage in margin squeeze until the checks have been conducted and it is directed to stop squeezing.

5.37 Such punishments for non-compliance should, of course, go beyond any gains made by BT and be explicitly punitive in nature if they are to incentivise BT not to engage in margin squeeze. If the punishment is only to remove the benefits of non-compliance then it would be utterly ineffective in providing any deterrent at all since the probability of detection will be less than 100%. Such an approach would be akin to making the only punishment for theft that the thief should hand back the stolen goods after having used them for a period of time, without further fine or other

sentence. EU competition law recognises this, and the European Courts have upheld very high fines for instances of non-compliance such as seal-tampering.

5.38 Under TalkTalk's proposed margin squeeze regime, we consider that there would be little scope for BT to inadvertently margin squeeze, and so there is likely to be very limited use of penalties for non-compliance. However, it remains important that penalties can be applied, as BT may otherwise face incentives to wilfully or negligently fail to adhere to the margin squeeze protection regime (for example, by entering data which is known to be untrue into the margin squeeze model). A combination of an *ex ante* system and significant penalties for failing to adhere provides the highest likelihood that there will be no need to fine BT at all for margin squeezing.

## 5.5 Level of aggregation of margin squeeze test

5.39 A further important issue which needs to be considered when putting margin squeeze protection into effect is the level of aggregation at which the margin squeeze test is conducted.

5.40 The two extreme cases would involve either:

- Only conducting a single test on all BT SFBB products taken together, with no tests undertaken on individual product bundles sold to customers. Such an approach would give BT complete freedom to cross-subsidise between different SFBB products, therefore allowing pricing well below cost on some products, offset by setting supernormal prices on other products.
- conducting the test on each individual bundle purchased by consumers. For example, one bundle might be BT Infinity 1, with TV Essential Extra, BT Sport in HD, Sky Sport, and added evening calls including new line provide. This would lead to a very large number of products being tested by BT, some of which would have very few customers taking them.

5.41 TalkTalk considers that both of these extremes are flawed.

5.42 Testing at a very aggregated level risks BT being able to continue to exploit its market power in an anti-competitive way. Within SFBB there is likely to be little benefit from Ramsey pricing, as elasticities of demand are likely to be relatively constant across products. Rather, aggregation will allow BT pricing flexibility that it will exploit to attack particular competitors and exploit its customers. For example, it could create very low priced and low margin 'fighting products' aimed at attracting the customers of TalkTalk.

5.43 An aggregated test would require an assumption for the proportionate mix of different products groups (e.g.the proportion on each of Infinity 1 and Infinity 2). This could not be known at product launch and so it is an assumption that BT could manipulate in order to pass the test. For example, say that BT was planning low (squeezing) margins on basic products and higher margins on higher-end products. It could assume that it would have a very high proportion of higher-end products in

its customer mix and thereby show that it passed the aggregate test. Obviously, such an assumption would be subject to gaming. If an aggregated check were used, then there would be a high likelihood of complaints after each product launch, as downstream competitor CPs would wish to check BT's assumptions on product take-up.

5.44 Where tests are undertaken at a very aggregate level there would need to be continual refiling every time there is a change in the pricing of one product. In addition, the *de minimis* rules would need to be substantially tightened (or removed) to prevent abuse. For example, in theory if the *de minimis* threshold were set at £25 of SACs averaged across all SFBB products, then a single product with a 5% share of BT's total SFBB base could have an 'introductory' discount of up to £500 applied to it while remaining within the threshold. This would make a mockery of the margin squeeze protection system. Therefore, the *de minimis* rules would need to be removed or apply to each individual product rather than at the aggregate level.

5.45 There are also a range of other problems with such a highly aggregated system, as set out in Annex 5.

5.46 A very disaggregated system, on the other hand, would result in many products needing to be tested and BT having to test products that very few customers buy.

5.47 Consequently, TalkTalk's preferred approach is to use a system of margin squeeze assessment which is intermediate to these two extremes. Under this system, there would be a few 'core product groups', consisting of the variations in three elements (the SFBB speed, the SFBB download allowance, and the TV product included). At the moment, BT's product portfolio is such that it would have six core products which would need to be assessed, which could be considered in a 3 x 2 matrix as follows.[7]

| | **Infinity 1** | **Infinity 1 Unlimited** | **Infinity 2 Unlimited** |
|---|---|---|---|
| **No TV** | | | |
| **TV** | | | |

5.48 This approach means that large numbers of individual product bundles will not have to be assessed, but also somewhat restricts BT's ability to use different products to attack one or more downstream competitors.

## 5.6 Calibration of elements of the model design

5.49 The effectiveness of the margin squeeze protection regime will depend not only how and when it is applied, but also how the assumptions used to assess whether there is a margin squeeze are derived. If the margin is set too low then BT Retail will continue to margin squeeze and efficient competition will not occur. Alternatively, if the required margin is too high then BT Retail may not be able to compete

[7] TalkTalk has here taken all of BT's TV products (TV Essential, TV Essential Extra and TV Unlimited Extra together. Depending upon the difficulty of undertaking such an aggregated assessment, it may be necessary for BT/ Ofcom to test each of these TV packages separately, resulting in up to 12 core product groups to be tested.

effectively, and efficiency may again be reduced, although there will still be strong competition since all non-BT ISPs using GEA will compete on a level playing field.

5.50 In this section we discuss the appropriate approach to calibrating the model. Obviously, for reasons of predictability and certainty the assumptions (along with the model itself) should be made transparent in advance in Ofcom's published (and consulted upon) approach. Further detail on the manner in which TalkTalk proposes that the margin squeeze model should be calibrated is set out in Annex 5.

### 5.6.1 Overall approach

5.51 In this section we briefly lay out our view on a number of general principles about the approach to setting assumptions, namely: whether the total product bundle should be tested or individual components; whether costs should reflect the higher costs of entrants; whether common costs should be included; whether it is assumed that the new entrant uses MPF or WLR; and whether to aim up or aim down. The question of what aggregation of products the margin squeeze test is carried out on is discussed above in section 5.5.

5.52 We consider that the margin squeeze test should apply to the total bundle that a customer purchases rather than individual components of the bundle. For example, many customers buy a dual play bundle that includes line rental, inclusive calls and broadband. The margin test should be based on the total revenues and total costs for all these components rather than the margin on each component (e.g. just the line rental component).

5.53 As set out at paragraph 11.288, Ofcom has outlined three different options for how the margin should be calibrated:

- (1) sufficient to allow BT to recover its costs;
- (2) sufficient to allow an efficient new entrant to match BT's retail pricing
- (3) sufficient to allow an efficient new entrant to significantly undercut BT's retail pricing

5.54 We agree with Ofcom that the second option is the appropriate one since it is consistent with Ofcom's duty to promote competition, while also avoiding the potential for undermining BT Retail's business – thereby leading to losses in productive efficiency – that Option 3 suffers from.

5.55 We also agree with Ofcom that it is appropriate that the margin squeeze model should include both incremental costs, and an appropriate allocation of fixed and common costs. This accords with the principle of setting the minimum margin to be one which allows efficient entry, as a potential entrant to the SFBB market would expect to recover a reasonable proportion of common costs from SFBB products.

5.56 Ofcom should use MPF, rather than WLR, as the efficient technology for determining the cost of provision within the margin squeeze model. This approach best reflects

Ofcom's aim of setting a margin which is sufficient to allow an efficient entrant to match BT's retail pricing.

5.57 TalkTalk considers that any efficient scale entrant would provide SFBB services using MPF not WLR. A scale entrant providing SFBB would also provide SBB (with SBB accounting for the majority of customers for the coming period). Such an entrant would use MPF (not WLR+SMPF) to provide SBB since this allows use of more modern and efficient technology (converged MSANs rather than DSLAMs plus PSTN); this is borne out in practice by TalkTalk's and Sky's actual behaviour.

5.58 Therefore, the issue is whether for such an operator (which is already using MPF to provide SBB) it is lower cost to provide SFBB services based on MPF or based on WLR (i.e. MPF + GEA or WLR + GEA). We believe it is more effective to provide services on MPF for several reasons, particularly:

- simpler and more consistent operating model
- lower migration costs for upgrading a customer (i.e. moving from MPF to MPF+GEA is lower cost than MPF to WLR+GEA)
- lower migration costs for downgrading

5.59 This theory is reflected in practice today where both TalkTalk and Sky (the only scale non-BT operators using Openreach's network today) provide SFBB over MPF (i.e. using MPF + GEA). A margin squeeze model based on WLR would therefore not be reflective of an scale entrant's genuine efficient costs.

5.60 Finally, where Ofcom is unsure about the true value of parameters, it should err towards requiring a higher, rather than a lower, margin (i.e. aim up). This is appropriate both because of the reduction in competition in the SFBB market which has already occurred due to BT margin squeezing, and which needs to be redressed, and because the economic damage likely to be caused by setting an excessive margin is less than that caused by setting an inadequately low margin which does not permit entry and that BT is likely to game to some degree.

### 5.6.2 Assumptions

5.61 In order to be effective, the margin squeeze model will need to be as clear as possible on the various assumptions which should be adopted to derive the parameters which populate the model. As such, Ofcom should issue detailed guidance on the manner in which parameters are derived.

5.62 This section provides some thoughts on the parameters which Ofcom will need to determine, and then gives examples of the way in which TalkTalk proposes that some critical parameters should be determined.

5.63 There are four major categories of parameter, and we consider that Ofcom will need to provide clear and detailed guidance on all of them:

- the revenue which can be considered to be derived from customers;

- the operational expenses incurred in serving those customers;
- the upfront SACs incurred in recruiting customers; and,
- the approach to valuation of the various parameters.

5.64 In general **revenue** should be relatively straightforward to determine. The different elements of this which are likely to need to be included in the model are:

- Fixed/recurring monthly charges for the core product such as line rental, broadband, and TV charges;
- Additional payments for optional or pay as you use services such as call packages, out of bundle calls, additional premium channels, VOD, or exceeding monthly download limits.

5.65 Which of these elements have revenue attributed to them, and the amount of revenue, will differ from product to product. There may also be a need for other elements to be added to this list over time, as product innovation occurs.

5.66 The revenue should be determined on a representative customer basis. That is, for elements such as out of bundle call revenue and premium channels, the system should assume in the average revenue per customer on that product, even where not all users have generate any revenue from this source.

5.67 **Opex** will also involve a significant number of different elements, and is in many cases likely to be the element which the model is most sensitive to. The main opex categories are:

- Wholesale charges (MPF rental, GEA rental, interconnection, event charges);
- Network costs such as exchange equipment (space, MSAN etc), backhaul/core, peering, voice specific components, GEA interconnection equipment;
- Product features (apps, safe surfing software, wifi etc);
- Costs of TV content (eg, BT Sport);
- Customer service, customer retention and bad debt; and,
- Commercial and overhead costs attributable to the retail business.

5.68 Two particularly important opex elements are content costs and backhaul/core network costs.

5.69 *Content costs (particularly BT Sport)*. BT's SFBB packages all include certain bundled content. It is essential that the cost of this content is included in the margin squeeze model (in the same way as the costs of other bundled features such as routers and virus protection are included). In particular, an allocation of the cost of BT Sport must be included in any margin squeeze assessment of SFBB.

5.70 The costs of BT Sport which are not met from direct revenues to BT (self-retail revenue over the Sky DTH platform, wholesale revenue derived from Virgin Media, sales to pubs and clubs, and advertising revenue) should be fully allocated to

broadband packages. This is because it is clear that the central purpose of BT Sport is to retain customers on broadband (and particularly SFBB).

5.71 The allocation of this total net cost between different broadband packages should reflect whether a customer is able to access the bundled sport content through their TV (e.g. over the Sky, YouView or Vision platforms) or only via another device (e.g. the BT Sport App on an iPad). In our view, there should be a very substantial per customer allocation of costs to SFBB products, given BT's commercial policy of bundling BT Sport through TVs with SFBB products at no additional charge, while not permitting access via SBB.

5.72 An alternative approach to estimating the costs of BT Sport would be on the basis of the cost for a non-BT ISP to replicate BT's offering. This would mean setting the cost on the basis of the wholesale charges that are levied for BT Sport, adjusted to the scale of the efficient entrant operator. However, this would require that BT are not continuing their *de facto* refusal to wholesale BT Sport to downstream CPs which use Openreach's network.

5.73 *Backhaul/core network*. The GEA product delivers traffic to the CP at about 1,000 exchanges. Therefore, an ISP has to provide network capacity to transfer this traffic to a central point and 'into' the Internet. For SFBB customers who use high amounts of bandwidth this is a substantial cost item.

5.74 The total cost of the backhaul/core network should be based on the costs for an efficient new entrant using BT's backhaul wholesale products (e.g. BES, EBD) and others networks. This total cost should be recovered across all broadband customers.

5.75 Since in the long run, the cost of bandwidth largely depends upon the volume of bandwidth required (rather than number of customers served), we consider that the appropriate manner in which to allocate the total cost between different products and customers is based on bandwidth consumption. As such, the appropriate allocation of costs is based on the average bandwidth consumed by a particular product.

5.76 Subscriber acquisition costs **(SACs)** will include a series of costs which are borne when a customer signs up for a new product. Amongst the relevant SACs are:

- Incentives (introductory discounts or vouchers);
- equipment (e.g. broadband routers/modems, set-top boxes);
- wholesale charges (GEA connection, new MPF line provision);
- sales and marketing costs and commissions to third party vendors.

5.77 As with other cost categories, where some costs are not incurred for all customers (e.g. new line provision charges) then a representative average customer approach should be used, with a percentage of the cost reflective of the proportion of the customer base causing it to be incurred is put into the model.

5.78 The final key element to calibrate the model is the approach to **valuation**. These elements enable all of the different costs and revenues to be included so as to come to a single figure for the overall profitability of a customer which shows whether it passes, or fails, the margin squeeze test. We think that the appropriate approach is an NPV calculation where the cash flows extend for the average life time of the customer. There are two main variables in the valuation approach: the customer lifetime which is used and the discount rate applied.

5.79 *Customer lifetime.* The most appropriate way to determine customer lifetime is to assess the customer lifetime which would be experienced by an efficient scale entrant into the market. The average customer lifetime can be derived from the churn rate (for the product):

*Customer lifetime = -1/ LN (1-churn)*

5.80 Using an efficient scale operator would fit with Ofcom's objective of promoting competition, and would be consistent with allowing an operator with a slight commercial drawback relative to BT profitably to match BT's retail SFBB price. It is important to note that it would likely be inappropriate to use BT's observed customer lifetimes for SFBB when assessing the appropriate customer lifetime for the purposes of populating the margin squeeze model. BT's current pricing – which involves a very large margin squeeze against its downstream rivals– will be distorting competition and consumer behaviour in the retail SFBB market, making it an inappropriate source of data. By margin squeezing, BT is providing itself with an artificial advantage in terms of the attractiveness of the price/features of its retail products. This will in turn reduce the customer churn which it experiences, as customers with less attractive alternative options will be less likely to switch away. As such, the levels of customer churn experienced by BT will likely be below those experienced by an operator which was not margin squeezing its rivals. In the absence of reliable data on SFBB churn for an efficient scale entrant, churn for SBB products could be used.

# 6 Cost of migrations

6.1 TalkTalk strongly supports Ofcom's position on the pricing of GEA-GEA migrations and no minimum contract period subsequent to a GEA-GEA migration. We consider that BT's current GEA migration charges are clearly excessive, and act as a significant barrier to switching between providers. They therefore enhance the degree of customer lock-in, benefitting BT and amplifying the harmful effects of BT's ongoing margin squeeze against other ISPs. We agree with Ofcom's position as set out in paragraph 11.171 that BT is using its market power to impede competition by setting an excessive migration charge.

6.2 We consider that there is no valid economic case for setting a migration charge in excess of LRIC. Indeed, we note that in many other industries (for example, banking and energy) there has been a concerted effort made to lower switching costs, even where this results in pricing below LRIC, due to the increases in competition which are seen in markets where customers are more willing to switch between providers.

6.3 TalkTalk's preference is therefore for the GEA migration charge to be set at zero, with BT being able to recover migration costs through its monthly GEA rental charges. We believe that such a proposal would maximise the overall efficiency of the market, with increased price competition between retailers more than offsetting any loss of efficiency from setting migration charges below costs.

## Conclusions

6.4 Overall, we strongly support the high-level approach taken by Ofcom in the FAMR. In our view there is a clear risk of BT abusing its dominant position and excluding downstream rivals from the SFBB market. In particular, in the absence of regulatory constraints such as those outlined in the Consultation, BT has very strong incentives to margin squeeze.

6.5 We also agree with Ofcom that, on balance, margin squeeze protection is more appropriate for the current stage of market development than a wholesale price cap would be to prevent abuse. The key concern for TalkTalk is the manner in which this margin squeeze protection is applied. It is vital that it is actually effective in preventing BT from margin squeezing downstream competitors, and is not neutered by BT gaming or inappropriate system design.

6.6 As such, it is crucial that products are tested prior to launch and before products are sold to consumers. An entirely *ex post* system risks irrelevance due to the speed of product turnover in the SFBB market. This can be done without imposing a large burden on Ofcom through Ofcom determining the method by which test are carried out and BT testing the products as part of its existing governance procedures.

6.7 Moreover, in any effective system of margin squeeze protection, the manner in which the various variables which are required for the model are determined is crucial. It will be vital for Ofcom to set out clear guidance for the appropriate method of calculating different costs and revenues, to ensure that all market participants are able to make well-informed decisions.

6.8 As a margin squeeze model will be required regardless of whether TalkTalk's proposal is adopted, or either Ofcom's Option 1 or Option 2, we believe that Ofcom should commence construction of such a model as soon as possible. By constructing a model now, it can be ready for stakeholder consultation immediately when Ofcom concludes on the most appropriate option for margin squeeze protection. This will accelerate the introduction of margin squeeze protection, and Ofcom will have the best opportunity of being able to commence the margin squeeze protection regime as soon as possible. Any delay after 1st April effectively provides a regulatory lacuna that can only allow BT to continue margin squeezing.

6.9 In summary, TalkTalk welcomes the current provisional thinking in the FAMR, and looks forward to working alongside Ofcom to refine it into an outcome which is as beneficial as possible for UK telecoms consumers.