OFCOM'S CONSULTATION DOCUMENT "PROPOSALS FOR WBA CHARGE CONTROL"

RESPONSE BY BSKYB

EXECUTIVE SUMMARY

1. Consumer broadband products in Wholesale Broadband Access (WBA) markets where there is little or no competition (i.e. Markets 1 and 2) are generally inferior compared to elsewhere (i.e. Market 3). Typically, prices are higher, speeds are slower and products are more likely to be subject to data usage caps.

2. By definition, BT is the only provider of WBA in Market 1 today and, while there could be some limited market entry by LLU operators over the next three years, BT will remain the only WBA provider from the vast majority of exchanges. In this context, the primary objective of the WBA charge control should be to ensure that BT is unable to earn excess returns and, thus, protect consumers from unnecessarily high pricing. A further objective of the charge control will be to promote only efficient and sustainable market entry and investment by BT.

3. We consider that these objectives are best achieved by basing prices on the Modern Equivalent Asset (MEA) because BT will be rewarded only on the basis of the forward-looking, efficient costs of the latest tried and tested technology.

4. While sometimes it can be difficult to identify the MEA, in this case, it is quite clear. MEA costs in Market 1 are based on the same technology that BT is deploying elsewhere (21CN[1]) and share many of the same inputs used by LLU operators when they unbundle Market 1 exchanges.

5. In this instance, therefore, Ofcom's anchor pricing approach, whereby the charge control is modelled on the (higher) costs of an ongoing 20CN[2], is unwarranted. It is not a proxy for the MEA nor is there any evidence that investment by BT in new technology is made any more likely as a result. In fact, there is a danger that

[1] ADSL2+ and Ethernet backhaul. BT 21CN WBA products include Wholesale Broadband Connect (WBC).
[2] ADSL1, ATM and SDH backhaul. BT 20CN WBA products include IPStream Connect.

allowing BT to earn high cash flows above the competitive level may actually disincentivise investment.

6. Regulated WBA prices would be significantly lower under an MEA approach. We estimate that over the three years of the charge control, BT will be able to earn at least £140m more under Ofcom's model. As a result, each of the c2m broadband consumers in Market 1 could pay £70 more than they need to.

7. The cost of bandwidth under anchor pricing is higher than it would be under an MEA approach. Either way, anticipated end user demand for bandwidth will continue to grow and will become the dominant cost component of WBA. Ofcom's forecast growth (23% p.a.) in the amount of bandwidth allocated to end users appears conservative. We recommend a higher growth rate assumption and subsequently prices should fall further than currently proposed.

8. Furthermore, consideration should be given to setting a separate price cap (or more stringent sub-cap) for end user bandwidth. Otherwise, there is a risk that average bandwidth allocations in Market 1 could fall further behind allocations elsewhere.

CONSUMER BROADBAND PRODUCTS IN MARKET 1 ARE INFERIOR TO THOSE IN OTHER MARKETS

9. Consumers have benefitted from the increased competition that followed market entry and investment in the "competitive" WBA Market 3. The technologies deployed in this market by LLU operators (ADSL2+ and Ethernet backhaul) and cable (DOCSIS3) have delivered faster speeds at lower retail prices compared to the legacy 20CN (IPStream) technology upon which BT used to rely in these areas.

10. In response, BT is rolling out Wholesale Broadband Connect (WBC) which is also based upon ADSL2+ and Ethernet backhaul. By spring 2011, WBC should be available to 75% of UK premises[3]. This level of coverage broadly equates to the footprint of Market 3[4].

11. However, in Markets 1 & 2 where cable availability and LLU roll-out is patchy, there is less competition for BT in the provision of WBA. Ofcom has found that BT has significant market power in these markets. Recently, large operators like Sky and TalkTalk have commenced a second wave of LLU roll-out which could result in some consumers in the "intermediate" Market 2 benefitting from increased competition and investment.

12. To date, however, there has been no competitive entry in Market 1 and, subsequently, the pricing and functionality of WBA and downstream retail broadband products in this market are generally inferior to that available in other markets. It is in this market that Ofcom is imposing a charge control on BT's WBA prices. Specifically, Ofcom is seeking to cap BT's IPStream Connect charges.

[3] http://www.thinkbroadband.com/news/4344-bt-announce-199-new-exchanges-for-wbc-adsl2-rollout.html
[4] Market 3 covers 77.6% of UK premises, *2010 WBA Statement* - http://stakeholders.ofcom.org.uk/binaries/consultations/wba/statement/wbastatement.pdf

13. The inferiority of retail broadband products in markets where there is little or no upstream competition in WBA is evident. The table below compares the broadband products that are available from the major consumer providers in Markets 1 and 3[5].

Table 1: Consumer broadband offers in Market 1 and Market 3

Source: Company websites

Sky		Talk Talk		Virgin Media		Plusnet		BT	
Market 1	**Market 3**	**Market 1**	**Market 3**	**Market 1**	**Market 3**	**Market 1**	**Market 3**	**Market 1**	**Market 3**
Sky BB Connect	Sky BB Unlimited	Talk Talk Plus	Talk Talk Plus	Broadband L	National Broadband XL	Broadband L	National Broadband XL	BT Broadband option 3	BT Broadband option 3
Upto **8mbps**	Upto **20mbps**	Upto **8mbps**	Upto **20mbps**	Upto **8mbps**	Upto **30mbps**	Upto **8mbps**	Upto **20mbps**	Upto **8mbps**	Upto **20mbps**
40GB limit	**Unlimited** downloads	**40GB** limit	**Unlimited** downloads	**20GB** limit	**Unlimited** downloads	60GB limit[4]	60GB limit[4]	Unlimited downloads	Unlimited downloads
£17.00 per month[1]	**£7.50** per month[1]	**£18.81** per month[2]	**£7.49** per month[2]	**£37.74** per month[3]	**£27.31** per month[3]	**£16.37** per month[5]	**£11.49** per month[5]	£25.60 per month[6]	£25.60 per month[6]

The operator offers are not comparable with each other. The aim is to illustrate difference in price between on and off net offers from the same operator.
1: Includes basic TV and evening and weekend calls, excludes line rental
2: Includes evening and weekend calls, excludes line rental. First 12 months then prices increase
3: Average for first 12 months. Line rental included.
4: Unlimited downloads between 12am and 8am
5: Average for first 12 months. Calls and line rental excluded.
6: Excludes line rental

14. In Market 1 all communications providers are reliant upon IPStream to supply retail broadband services. Therefore, retail products in this market are;

- Slower – as IPStream is based upon ADSL1 which only offers speeds of "Up to 8Mb/s" compared to the "Up to 20Mb/s" ADSL2+ speeds that are available elsewhere[6];
- More expensive - on average, LLU operators and cable charge approximately £10 less per month for their on-net broadband products compared to off-net, while Plusnet[7] charges £5 less; and
- Subject to more usage caps - LLU operators and cable offer unlimited downloads to on-net customers but apply download limits to their off-net broadband services.

Only BT Retail maintains pricing parity and unlimited downloads nationally but its prices are typically higher than those of its competitors.

IT IS IMPORTANT THE CHARGE CONTROL PROTECTS CONSUMERS FROM HIGH PRICES WHILE INCENTIVISING EFFICIENT AND SUSTAINABLE MARKET ENTRY AND INVESTMENT

15. As shown above, the consumer benefits that result from market entry and increased investment are demonstrable. Where LLU, cable or WBC roll-out occurs consumers are offered broadband products that are faster, cheaper and often without usage caps. However, while entry has occurred elsewhere, in Market 1 the

[5] In fact, Sky and TalkTalk are able to offer on-net services to some consumers in Market 2 as well.
[6] It should be noted that slower speeds in Market 1 are not solely explained by the technology constraints of 20CN but also due to longer average line lengths compared to Market 3.
[7] Plusnet is a subsidiary of BT.

prospect of increased wholesale competition is more limited and, for most exchanges, BT will remain the only provider of WBA services.

16. Given this context, it is essential that the new WBA charge control prevents BT from earning excess returns and, thus, protects consumers from high prices. Further, it is important that the right investment signals are sent to both potential new entrants and BT in Market 1. If prices are set too high, they could encourage inefficient and unsustainable market entry.

17. There is a prospect of limited market entry by LLU operators[8] and some future investment in 21CN technology by BT as scale and scope economies increase due to falling technology costs and increased broadband penetration.

18. Thus far, where LLU operators have extended their coverage, subscribers served from newly unbundled exchanges are offered exactly the same cheaper, faster, unlimited retail broadband products as the LLU operator's other on-net customers. These products are typically cheaper and better than the retail products offered by BT in Market 1. BT is likely, therefore, to lose retail and wholesale market share if it fails to respond.

19. Ofcom accepts the likelihood of this outcome by modelling a 1.5% reduction in IPStream volumes as a direct result of TalkTalk's market entry[9]. For a minority of Market 1 areas, therefore, BT may lower its retail prices and/or increase broadband product functionality to counter this increased competitive threat. Such a response would be consistent with BT's previous reaction to wholesale market entry by LLU operators i.e. investing further by extending its WBC footprint.

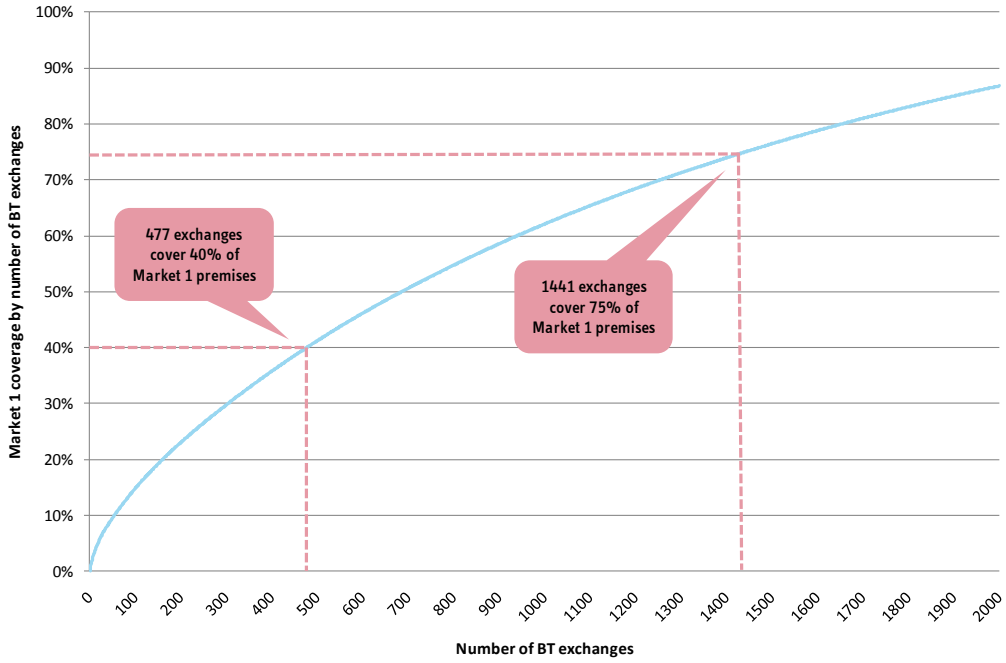
20. BT has yet to announce plans to extend WBC coverage. It has an incentive, however, to withhold any such announcement until after the WBA charge control is finalised. This is because, if BT announced any expansion plans beforehand, then the central plank of Ofcom's case for setting prices above their forward-looking competitive level – to incentivise further investment by BT - would be removed and, thus, the charge control settlement could be lower.

21. It would appear, however, to be entirely practicable for BT to extend its WBC footprint into Market 1. For example, BT has taken little over three years to deploy WBC to 75% of UK premises, equating to around 1,500 exchanges. The minimum number of Market 1 exchanges to which BT would need to roll out WBC in order to match TalkTalk's planned 40% coverage would be 477.

[8] Although the timeframe is uncertain, TalkTalk's recently announced plans to extend its LLU footprint to 2,700 exchanges, covering 93% of the population, equating to over 40% of Market 1 premises.
[9] Paragraphs 5.73-5.74, *Proposals for WBA charge control*

Figure 1: Market 1 coverage by number of BT exchanges

Source: Sky/PointTopic



IT IS APPROPRIATE TO SET PRICES ON THE BASIS OF THE MEA

22. Given the risk of excessive pricing and the prospect of limited market entry, it is appropriate, if at all possible, to set prices on the basis of the MEA. An MEA approach to setting regulated charges guarantees that the regulated firm is only rewarded for the forward-looking, competitive costs of WBA provision. This protects against the regulated firm earning excess profits.

23. Indeed, Ofcom's "*standard approach*" is to set charge controls on this basis:

> *"Our standard approach to setting charges is to base costs on what is believed to be the most efficient available technology that performs the same function as the old technology"* [10]

24. Given this preference, any departure from the "*standard approach*" needs to be adequately justified by Ofcom. We do not consider that Ofcom has made the case for departing from the MEA approach in this instance.

[10] Ofcom, op cit, paragraph 3.39.

THE MEA FOR WBA IN MARKET 1 IS IDENTIFIABLE

25. It is sometimes difficult to identify the true MEA. Even if other operators are deploying tried and tested modern technology, it is not always clear exactly how the newer technology could be incorporated into the regulated firm's network.

26. However, in the case of WBA in Market 1, the latest technology and how it would be deployed is evident. BT would use 21CN technology (WBC) just as it has done throughout Market 3. WBC is based on ADSL2+ and Ethernet backhaul. The costs and topologies of these technologies are stable and well understood. In this respect, there is a significant overlap in BT's cost profile for rolling out 21CN into Market 1 exchanges and the cost profile of LLU operators unbundling exchanges in the same market.

27. Indeed, Ofcom admits that 21CN technology could be the MEA in this instance:

> *"In the present case, it might be argued that 21CN technology is the MEA, because it is a proven technology in Market 3 areas (and is similar to that used by some LLU operators in their networks) and it is likely to be what a new entrant would install now."*[11]

28. BT's WBC investment in Market 3 has been made in response to a combination of market entry by LLU operators offering faster and cheaper retail broadband products and greater scale economies stemming from higher broadband penetration rates and lower technology costs. This demonstrates that the MEA is 21CN-based and that 20CN technology in these areas is obsolete.

29. Ofcom, however, resists adopting an MEA approach to the charge control partly on the basis that costs are uncertain:

> *"Although 21CN has been rolled out in Markets* [sic] *2 and Market 3 areas, the costs of rolling out to Market 1 are still largely unknown. 21CN investment involves both the replacement cost of legacy DSLAMs at each local exchange and the cost of any necessary upgrades from SDH based ATM backhaul used in 20CN to Ethernet. These costs will depend on the specific circumstances at each exchange and are the source of uncertainty around costs."*[12]

30. This argument is without foundation. Modern equivalent asset costs in these areas can be easily calculated. BT has already replaced DSLAMs and upgraded backhaul circuits in well over a thousand exchanges already. Indeed, not only has TalkTalk being able to calculate the costs of unbundling nearly 500 Market 1 exchanges, but it is inconceivable that BT has not conducted its own assessment of the viability of rolling out 21CN to Market 1.

[11] Ofcom, op cit, paragraph 3.39.
[12] Ofcom, op cit, paragraph 3.56.

AN MEA APPROACH IS MORE ROBUST THAN ANCHOR PRODUCT PRICING

The hypothetical ongoing network is not a proxy for the MEA

31. Rather than basing the WBA charge control on readily identifiable, stable and predictable modern technology costs, Ofcom has instead chosen to model a "hypothetical ongoing network" (also described as an "anchor pricing" approach) based upon BT's current technology costs.

> *"There are circumstances where Ofcom does not set charges on the basis of MEA costs. When faced with major shifts in technology we would consider adopting a more cautious approach and set prices based on the hypothetical continuation of the existing technology until the new one becomes well established and prices can gradually move to reflect this."*[13]

32. Where MEA costs are uncertain, it may be justifiable to use a more reliable, alternative proxy for forward-looking competitive costs. However, in this instance, given the predictability of the 21CN-based MEA, there is no need to do so.

33. Moreover, the anchor pricing approach that Ofcom proposes is explicitly not a proxy for the MEA. Instead, Ofcom believes that, by setting prices on the basis of more expensive and less efficient legacy technology, BT could be incentivised to invest in newer technology because it can keep any additional efficiency savings. As such, it is clear that Ofcom is choosing to set charges above their forward-looking efficient level and, thus, explicitly allowing BT to continue to earn high returns:

> *"We recognise that the anchor pricing approach may not necessarily achieve allocative efficiency, because prices may not always equal costs, but we attach less weight to trying to achieve allocative efficiency at every point in time."*[14]

34. As we have pointed out above, it important that Ofcom's approach to setting the charge controls is one that incentivises efficient investment. By deliberately setting charges above the level of efficient forward-looking incremental costs, there is a danger that unviable market entry and inefficient investment is encouraged.

Ofcom's hypothetical cost modelling is speculative and subjective

35. In order to value the hypothetical ongoing network, Ofcom recalibrates BT's Current Cost Accounting (CCA) valuations of WBA within its Regulatory Financial Statements (RFS) – which, themselves, are not MEA based but represent BT's own view of the ongoing value of its 20CN network.

36. Effectively, both BT's and Ofcom's valuations assume a level of capex for the legacy network above its true cost while modelling lower opex. This has the effect of increasing the net replacement cost of the network and, as a result, the charge control is set higher than would otherwise be the case and on the basis of a technology that would not be used by a new entrant or by BT if it were replacing the network today.

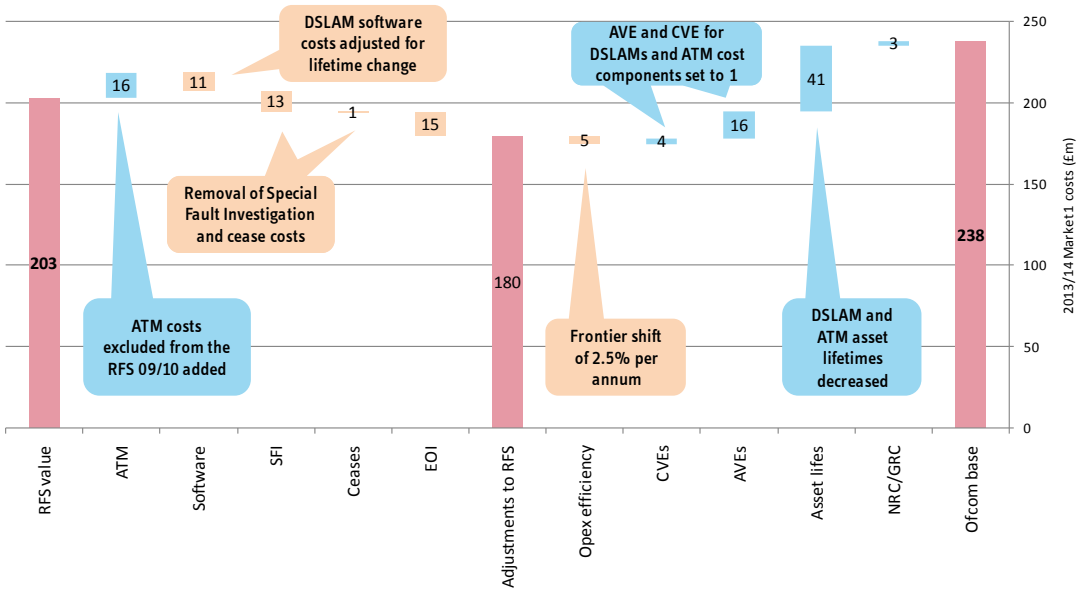
[13] Ofcom, op cit, paragraph 3.42.
[14] Ofcom, op cit, paragraph 3.53.

37. Figure 2 shows the adjustments that Ofcom makes to BT's RFS valuation of £203m by 2013/14 in order to;

    - strip out costs that are out of scope for the charge control, such as Special Fault Investigation charges; and
    - add in missing ATM costs.

    This results in an adjusted RFS figure of £180m. From this point, Ofcom makes a series of further adjustments to model its view of the hypothetical ongoing network. These include increasing the assumed level of additional assets and costs required to deliver an additional unit of output[15] and shortening the asset lives of some equipment (which has the effect of increasing depreciation costs).

Figure 2: Ofcom adjustments to WBA Market 1 RFS costs (2013/14)



38. As a result, in 2013/14, the hypothetical ongoing network model adds a further £58m (32%) to BT's own (adjusted) valuation of its 20CN network in Market 1.

39. Given the subjective nature of these adjustments, it is not credible to argue that, simply because the model is based upon technology that BT is using today, the anchor pricing approach is more robust than an MEA one.

<u>It is unproven that the anchor pricing approach incentivises investment</u>

40. While Ofcom has used this approach before, there is no evidence to suggest that it works in the way that Ofcom describes.

[15] These are known as Asset Volume Elasticities (AVEs) and Cost Volume Elasticities (CVEs).

41. Where it has been used there has either been no subsequent investment at all in new technology by BT or, where investments have occurred, they were already being executed prior to the adoption of anchor pricing. For example;

    - Ofcom set the Network Charge Control (NCC) for 2009 - 2013 on the basis of a hypothetical ongoing network model using legacy Time Division Multiplexing (TDM) cost inputs. To date, there has been no material investment by BT in new NGN[16] functionality. As a result, BT has earned revenues in excess of either its historical costs or forward-looking modern technology costs; and

    - In the Leased Line Charge Control (LLCC) for 2009 - 2013, Ofcom based the price caps for low bandwidth alternative interface symmetric broadband origination (AISBO up to and including 1 Gb/s) on the economics of point-to-point Ethernet circuits like BES and WES. However, Openreach was already deploying shared fibre solutions that exploited Dense Wave Division Multiplexing (DWDM) via its Orchid portfolio. BT Wholesale was in the process of moving to these products to underpin its WBC roll out. Ofcom's approach was entirely unnecessary. It merely over-compensated BT in an attempt to incentivise it to undertake investments that were already underway and central to the ambitions of the BT Wholesale and its customers, including BT Retail.

<u>It is equally plausible that allowing BT to earn high returns could actually disincentivise further investment</u>

42. Ofcom argues that, under its anchor pricing approach, where charge controls are based upon the replacement costs of its current network, cost-reducing investment by BT during the future charge control period will be rewarded in the form of temporarily higher profits.

43. In reality, however, should BT fail to invest in 21CN throughout Market 1, then the costs of running the existing network will be significantly lower than those estimated through the anchor pricing approach which assumes a level of ongoing capital investment which would not occur in practice. On a true cash-flow basis, the sweating of its 20CN network would be highly profitable and relatively riskless for BT.

44. For the incentive properties of the anchor pricing approach to be effective, the increased profits from investing in newer technology must outweigh those that arise from continuing with the current technology. However, it is likely that the increased profits stemming from further investment will only be temporary as, in subsequent charge controls, they could be removed as Ofcom adopts 21CN as the cost benchmark instead of 20CN.

45. Conversely, if BT instead chose not to invest in 21CN, then it would be likely that the next time Ofcom set the charge controls it would continue to base costs on 20CN to stimulate investment. Given this uncertainty in future returns, it is likely

[16] Next Generation Networks

that investment will be less appealing compared to the certain, (high) profitability of maintaining existing assets.

46. In summary, Ofcom is required to demonstrate that its widely-used anchor pricing approach delivers tangible benefits by encouraging investment (which would not occur otherwise) that, in the long term, delivers lower prices and increased functionality for consumers. It is our view that, to date, there is no such evidence.

CHARGES SET ON AN MEA BASIS WOULD BE SIGNIFICANTLY LOWER

47. Ofcom's anchor pricing approach deliberately sets prices above the forward-looking competitive level based on the latest tried and tested technology. This is in direct contrast to Ofcom's (stated) normal preference to rely on the MEA.

48. In order to gauge the impact of Ofcom's approach compared to an MEA based one, Sky has estimated the costs of rolling out modern technology to Market 1 exchanges (including subscriber migration costs). These costs are a reasonable estimate of the forward-looking incremental (plus some mark up for common costs) that both a new entrant and BT would be able to recover in a competitive market. They include the costs of installing new exchange-based equipment (MSANs/ISAMs), Ethernet backhaul circuits and migrating or connecting subscribers to the new service.

49. Sky's cost estimate is higher than a true MEA valuation because it does not include the adjustments (so-called "abatement factors") that would need to be made under a proper MEA approach. Typically, for the purposes of setting a charge control, MEA costs would be adjusted downwards to account for the greater capabilities of the new technology compared to the old equipment. Abatement factors include;

    - additional functionality;
    - improvements in output; and
    - operating cost savings

50. The resulting "net" MEA value represents the value that should be placed on the current asset in use for the purpose of setting the charge control. Effectively, the delta between the (higher) current asset valuation and the (lower) "net" MEA value is the amount by which the current asset should be abated.

51. Ofcom cites practical difficulties in estimating these abatement factors as further justification for deviating from an MEA approach to pricing and adopting its anchor pricing approach instead[17]. However, it is clear that prices would be significantly lower under an MEA model and that Ofcom is explicitly setting charges well above the forward-looking, modern equivalent level in order, it claims, to incentivise investment. Ofcom is confusing its policy objectives. Either it wishes to base

[17] Ofcom, op cit, paragraph 3.43.

charges on the MEA and, therefore, needs to overcome the practical difficulties involved or these practical difficulties are an irrelevance and Ofcom wishes to set prices well above the "competitive" level for dynamic efficiency and (future) productive efficiency reasons.

52. This is not a frivolous issue. There is a significant difference in likely charges that result from an MEA approach as opposed to the anchor pricing approach.

53. Figure 3 shows the adjustments that could be made to Ofcom's cost model to replicate a 21CN MEA approach to setting the charge control. In Ofcom's anchor pricing approach prices are expected to fall by RPI-12.75% annually over the next three years. Whereas, by replacing 20CN costs with 21CN costs, an MEA based charge control could be in the order of RPI-20% or more.

Figure 3: Impact on X - Ofcom base case vs. Sky's 21CN approach

[✂]

54. If prices would need to fall by the amounts indicated by the MEA approach then there is a very strong case for immediate one-off price reductions at the start of the charge control period. Typically, where prices are materially out of line with their costs, Ofcom considers whether one-off price reductions are required at the start of the charge control. This is because, if the glide path is too steep due to a high X value, then the regulated firm will be earn high returns for the majority of the charge control period.

55. Where this issue has arisen in the past, Ofcom has made on-off price reductions. Examples include the imposition of a 17% price cut for Openreach's 1 Gb/s Ethernet backhaul rental (BES1000) at the start of the leased line charge control in

2009 and various one-off changes to key LLU and WLR migration services in the 2009 Openreach Financial Framework Review.

56. By maintaining prices above the competitive level, the anchor pricing approach will result in a transfer of funds from consumers to BT over the period of the control in the (unproven) hope that longer term dynamic and productive efficiencies (that would otherwise not be unlocked) will accrue and, crucially, that these will outweigh the short term consumer welfare losses that stem from higher prices. This is a highly speculative approach.

57. Over the course of the WBA charge control, we forecast that BT will earn at least £140m more in revenue than it would under our (extremely conservative) 21CN approach. This equates to each broadband consumer in Market 1 paying c£70 extra compared to an MEA based charge control.

Figure 4: Comparison of BT's revenues - Ofcom base case vs. Sky's 21CN approach

[✂]

Taking into account abatement factors that would reduce current asset values even further than we have estimated, consumer welfare losses are likely to be considerably higher.

THERE SHOULD BE A SEPARATE CONTROL, OR A MORE STRINGENT SUB-CAP, FOR BANDWIDTH CHARGES

58. There is another consequence of adopting 20CN as opposed to 21CN as a basis for setting the charge control. Bandwidth is considerably more expensive on ATM/PPC backhaul then it is with Ethernet backhaul. This is important considering the anticipated growth in bandwidth usage during the charge control period. By basing charges on the legacy technology, prices for bandwidth would be higher than under a MEA approach. ISPs, as a result, will be constrained in allocating more bandwidth to their end users.

59. While consumers would be better served if the charge control were based on the MEA, whichever approach Ofcom adopts, it is clear that bandwidth demand will continue to grow over the relevant period and, as such, bandwidth will become an increasingly dominant proportion of underlying WBA costs.

60. We consider that Ofcom's estimated annual growth in allocated bandwidth per end user is conservative compared to Sky's on-net end user allocations (although we accept that the scope for WBA bandwidth growth is inhibited by ADSL1 technology).

61. As Sky's on-net allocations have risen by [✂]% annually over the last three years, a more prudent forecast for the purposes of the charge control would be nearer Ofcom's upper bound in its sensitivity analysis (35% compared to 23% in the base case). We note that Ofcom's forecast growth is merely an extrapolation of one year's worth of data and, as such, is likely to be unreliable.

62. If Ofcom adopted the more realistic higher bound (35% growth), then under Ofcom's modelling prices would need to fall annually by RPI-13.75% as opposed to RPI-12.75% in its base case. By adopting the base case, Ofcom could allow BT to earn c£100m in extra revenue.

63. Market 1 consumers of broadband are becoming increasingly disadvantaged by the high cost of IPStream bandwidth. Average end user bandwidth allocations (in kbps) are considerably below those in Markets 2 and 3 - as shown in figure 5.

Figure 5: Comparison between on an off net average peak allocated bandwidth

[✂]

64. It is clear that bandwidth consumption is growing more quickly in Sky's on-net areas compared to off-net allocations. As such, there is a growing divide in the functionality of the retail broadband products offered in Market 1 and elsewhere.

65. Given these circumstances, Ofcom's proposed charge control basket structure that allows BT to choose whether to apply price reductions to end user rentals or bandwidth is too broad and, as a result, could result in consumers with higher bandwidth consumption subsidising consumers with lower usage (or vice versa). As consumers in this market are already receiving bandwidth allocations considerably below average allowances elsewhere, this could drive additional dissatisfaction with the growing divide between rural and urban broadband.

66. Ofcom can mitigate these risks by ensuring that price reductions under the charge control are more narrowly focussed. This could be achieved by disaggregating the proposed basket so that end user rental and bandwidth prices are controlled separately, or by applying more stringent sub-caps that guarantee that prices for these two key components track the overall basket cap (currently proposed to be RPI-12.75%) more closely.

CONCLUSION

67. In short, Market 1 customers are under-served by today's retail broadband products. They are too slow and too expensive. Limited wholesale market entry and future investment could foster improvements in broadband functionality and

pricing in some of this market so it is important that entry and investment are efficient.

68. More importantly, throughout the charge control period, BT will retain SMP in Market 1 and will be the only WBA provider from most exchanges. Therefore, consumers need to be protected from excessive pricing.

69. Ofcom's anchor pricing approach risks incentivising inefficient market entry and investment. Moreover, while there is no evidence that the anchor pricing experiment works, Ofcom expects Market 1 consumers to pay higher prices today on the promise of uncertain dynamic and (future) productive efficiencies.

70. An alternative approach of setting prices on the basis of a known, stable and predictable MEA is likely to deliver more efficient investment and guard against high returns.

Sky **March 2011**