**RESPONSE BY BRITISH SKY BROADCASTING GROUP PLC**
**TO OFCOM'S CONSULTATION DOCUMENT "REVIEW OF THE WHOLESALE BROADBAND ACCESS MARKETS – CONSULTATION ON MARKET DEFINITION, MARKET POWER DETERMINATONS AND REMEDIES"**

## EXECUTIVE SUMMARY

1. There is a long tail of local exchanges serving a minority of the premises within the U.K. where it is highly unlikely that any operator other than BT will ever be present. Put simply, there is insufficient subscriber density to warrant an LLU operator, for example, unbundling these exchanges. Neither are there close substitutes for retail fixed broadband that are based on alternative technologies to wholesale broadband access over copper, fibre and cable. This leaves BT able exploit its dominant position in the supply of wholesale broadband access in these areas unfettered by the prospect of market entry by its competitors. This area is defined by Ofcom as Market 1.

2. There is an intermediate market between Market 1 and Market 3 (the fully competitive areas where most LLU roll out has been focussed thus far). This intermediate market (Market 2) is not yet fully competitive but there has been some limited market entry and the prospect for further entry or expansion remains a possibility. During the course of the forthcoming review period, however, it is unlikely that the competitive constraints exerted by the limited presence of one or two LLU operators will become sufficient to restrict BT's ability to exercise its market power.

3. The risk that BT could set either excessive or predatory wholesale broadband access prices, or commit a margin squeeze, has long been acknowledged and, as a result, BT offered voluntary pricing commitments. Despite loss of market share to LLU operators, these voluntary price floors and ceilings have failed to dampen BT's increasingly high returns from wholesale broadband access.

4. As these voluntary commitments fall away and the full extent of profitable LLU roll out becomes apparent, it is appropriate to consider whether some form of regulatory pricing control is merited in those markets where BT is dominant in order to protect consumers.

5. This is important because broadband consumers in these areas have traditionally experienced an inferior service. Typically, retail prices are higher and functionality inferior relative to broadband products in Market 3. In part, this can be attributed to

the lack of scale economies available from less densely populated exchanges. However, given BT's market power, it is important to prevent monopoly rents and to ensure that prices are a true reflection of costs.

6. However, in Market 2, a trade-off needs to be struck between these static efficiency considerations and the dynamic efficiencies that would flow from further investment by LLU operators in the form of lower retail prices and improved product functionality.

7. Therefore, given these conditions, there is a strong case for

   - a charge control and cost orientation condition in the areas where the prospect for competition is weakest (i.e. Market 1) and;

   - a cost orientation obligation in Market 2 where competitive constraints are weak but there remains some scope for further unbundling.

## SECTION 1. MARKET DEFINITION

*Geographic Market Definition*

1.1 Ofcom last conducted a review of the Wholesale Broadband Access ("WBA") market in 2008. It is unsurprising, therefore, that there have not been any significant changes to the conditions of competition or the structure of markets over the last two years that merit an alternative approach to market definition by Ofcom. There has been little movement of exchanges between the three markets and, therefore, the proportion of end users served from each of the three markets.[1]

1.2 In Market 1, because there is a large number of BT exchanges that serve a low number of premises, the cost of unbundling can be too prohibitive (or to put it another way, required market penetration is unrealistically high for any new entrant). However, due to its unique position, BT has a near-total monopoly in the supply of wholesale broadband access and, as such, absorbs all the available scale and scope economies in this market. The prospect for market entry is very weak.

1.3 Furthermore, not only is there no competition in Market 1 but the absence of close substitutes to the downstream retail fixed broadband services supported from this wholesale market is likely to persist for the duration of this review period. As we discuss below, broadband services delivered over other access technologies are likely to remain significantly different in terms of pricing, functionality and availability for them to be able to exert any significant constraint on retail fixed broadband during the course of the review period.

1.4 As a result, there are marked differences in competitive conditions in these areas compared to the largest exchanges (as evidenced by LLU operators' current level of market entry as well as their future roll out plans which generally exclude the long tail of exchanges that serve the last 14.2% of premises in the U.K.).

1.5 While Market 1 is typified by high barriers to market entry, there is an intermediate market (Market 2) where the business case for further unbundling by LLU operators is more marginal. In these intermediate areas, where the number of consumers served by a single exchange begins to increase relative to Market 1 and, subsequently, the retail market share required for viable market entry starts to fall, it is probable that certain LLU operators could justify further roll out.

1.6 Since the last market review in 2008 there has been some limited entry into Market 2. However, the market conditions that make Market 2 sufficiently different to Market 3 remain i.e. high barriers to entry and a lack of common pricing constraint resulting in higher wholesale prices[2].

1.7 Ofcom is not proposing to alter the geographic market definitions to reflect recent retail market consolidation. The threshold number of primary operators in Market 3 will remain at four (with no reduction to account for these market changes).

1.8 This is a reasonable approach. While there has been some consolidation (e.g. TalkTalk's purchase of Tiscali), there has also been LLU market entry (e.g. 02) and exit

[1] Market 1 is where only BT is present in an exchange, Market 2 has 2 or 3 primary operators present & Market 3 has four or more.
[2] BT offers certain IPStream/Wholesale Broadband Connect discounts in Market 3 but not in Markets 1 or 2.

(e.g. Orange plans to migrate their subscribers to BT's wholesale broadband access). Sky considers that these changes have not changed the competitive conditions of the three markets to a material extent.

*Super-fast broadband*

1.9 Recently, new broadband services offering faster connection speeds have been launched by both BT Retail and Virgin Media. These faster broadband services are made possible, in part, because fibre optic connectivity has moved further towards the customer premises. As of yet, adoption of super-fast broadband has been relatively modest with the price of current generation broadband acting as a constraint. Virgin Media recently announced that 57,900 customers (out of nearly 4 million broadband customers) take its 50Mb/s broadband product[3].

1.10 This suggests that, at the present time, there remains an unbroken chain of substitution between current and future generation broadband services whereby the prices of higher speed broadband products are constrained by the prices of lower speed, current generation services. As such, it is appropriate to redefine the WBA market definition so that all broadband services supported over copper, coax and fibre are within the same market.

*Virtual Unbundled Line Access ("VULA")*

1.11 For current generation broadband, "passive" products such as LLU represent the deepest point in the network from where wholesale competition can be effective and sustainable and confer the greatest level of flexibility and control to the LLU operator. Anything downstream of this point that is managed and aggregated is classed as "active". For current generation broadband, active products have resided within the Wholesale Broadband Access market and passive products have been in the Wholesale Local Access market.

1.12 However, for fibre-based broadband, presently the deepest point from where effective competition will flourish could be concentrated on active products like Openreach's Generic Ethernet Access ("GEA"), which is not a purely passive product. GEA has the potential to mimic to some extent the flexibility and control that is normally associated with passive products. In the Wholesale Local Access ("WLA") market review, Ofcom has defined the characteristics for Virtual Unbundled Line Access ("VULA") that products like GEA would need to exhibit in order for them to be considered sufficiently flexible and unconstrained to represent the deepest economically viable point in the network.

1.13 Whilst a fully flexible GEA product that conforms with the VULA characteristics would reside within the WLA market, any managed, wholesale super-fast broadband service offered by BT (i.e. as a fibre-based alternative to IPStream) that exhibits the following characteristics – aggregation, highly specified functionality, service specific and shared capacity – would more appropriately reside in the WBA market.

[3] Page 4, Virgin Media press release): http://phx.corporate-ir.net/External.File?item=UGFyZW50SUQ9NDMwMDN8Q2hpbGRJRD0tMXxUeXBlPTM=&t=1

*Business & residential*

1.14 We also consider that there is a chain of substitutability between business and residential broadband. While businesses will be interested in premium broadband products that offer higher care levels, service level guarantees, lower contention rates, business grade routers and so on, the price premium that these businesses are prepared to pay will be constrained by residential broadband product pricing.

*Other technologies*

1.15 While, for the time being, current and next generation broadband services delivered over coax, fibre and copper reside in the same market with a clear chain of substitutability, there are sufficient differences in broadband services delivered over satellite, fixed wireless or mobile to merit their exclusion from the WBA market.

## SECTION 2. MARKET POWER

2.1 By definition BT is the only supplier of wholesale broadband access in Market 1: there are no other operators present in these areas and, as we have discussed already, the low number of consumers connected to each of the exchanges in this market make it highly unlikely than any operator could justify entering this market. As a result it is clear that BT has SMP in this market, and there is little prospect of BT's market power diminishing over the period of this review. Therefore, without any regulatory constraint, BT would be able to exploit its market power to the detriment of consumers.

2.2 In the intermediate Market 2, while there has been limited market entry by LLU operators, there remains the prospect of some further entry (as LLU roll outs are extended). However, the state of competition in this market is still fragile. Future unbundling costs could rise (e.g. MPF, Co-Mingling costs etc.) and retail price reductions for both broadband and telephony could reduce the viability of further unbundling for some operators.

2.3 It is evident that the level of competitive constraint on BT in Market 2 is currently insufficient to prevent it from exerting its market power. Despite LLU operators who have entered Market 2 offering the same level of functionality and retail pricing as they do in Market 3:

- BT's IPStream pricing for Market 2 does not offer any volume rebates as it does in Market 3
- BT does not make available in Market 2 the enhanced functionality that it has recently rolled out into Market 3 (such as ADSL2+).
- Just as in Market 1, consumers in Market 2 quite often experience higher prices and lower levels of functionality through slower speeds, more traffic shaping and lower usage caps than consumers in Market 3.

2.4 It is apparent that neither the presence of a single LLU operator in all of the Market 2 exchanges nor the limited presence of other operators in a subset of these exchanges, is sufficient to constrain BT from acting independently of its competitors.

## SECTION 3. REMEDIES

### *General Access and Non-Discrimination*

3.1 On the basis that BT has significant market power in both Markets 1 and 2, without regulatory constraint, BT would have the ability to exploit its market power by discriminating in favour of its downstream businesses, to the detriment of LLU operators who are reliant upon IPStream in order to offer retail broadband services nationally.

3.2 BT could refuse to supply wholesale broadband access to other communications providers or offer an inferior set of products compared to those that it consumes internally.

3.3 As such, we support the re-imposition of General Access and Non-Discrimination obligations on BT in these markets.

### *Market 1 – Charge Control*

3.4 The nature of Market 1 areas is such that the likelihood of material market entry over the course of the review period is remote and, thus, BT is not subject to any competitive constraint. Without any control on prices BT would be able to earn monopoly rents, as a result, consumers would be deprived of welfare benefits that flow from competitive retail pricing. Lower wholesale prices would also enable LLU operators to narrow the gap between the prices and functionality of their on-net and their off-net broadband products[4].

3.5 This risk of monopoly rents is not new and was anticipated when BT made its voluntary IPStream pricing commitments. As these commitments are now expiring, it is appropriate to consider whether formal constraints should be applied to BT's pricing to protect consumers from the exploitation of market power while allowing BT to make a reasonable rate of return.

3.6 In fact, the case for constraining BT's prices is stronger today than it was when the commitments were made because, if anything, BT's ability exploit its market power has strengthened. What little indirect constraint that narrowband internet dial-up may have initially exerted on the retail broadband market has almost entirely gone and, as discussed above, no other close substitutes have emerged to take its place.

3.7 Moreover, the full extent of profitable LLU roll-out has now become more certain than before. It is increasingly clear, that the likelihood of unbundling in Market 1 is very low.

3.8 These factors coupled with the end of BT's voluntary pricing commitments make it entirely appropriate to introduce a charge control in Market 1. Under a charge control, not only will BT be able to make a reasonable return and consumers be protected from the risk of monopoly rents but also, under an RPI-X model where prices glide to fully allocated costs over the control period, there will be a framework for efficiency

[4] LLU operators off-net broadband products are typically more expensive, traffic shaped and subject to more stringent usage caps than their on-net counterparts.

improvements. This is important in markets where there is insufficient competitive constraint. Given that consumers in this market quite often pay higher prices for inferior broadband products, it is essential that costs are minimised.

### *Market 2 – Cost Orientation*

3.9 Unlike Market 1, BT is subject to limited competitive constraint in Market 2. We consider that there is a greater prospect of further market entry,[5] but that this is unlikely to be sufficient to constrain effectively BT's wholesale broadband access prices during the course of the review period (for the reasons we have outlined in the Market Power section above).

3.10 As BT's voluntary pricing commitments lapse, it is therefore appropriate to consider whether regulatory pricing remedies should be imposed on BT. The lack of sufficient competitive constraint and the expiry of its pricing commitments mean that BT could increase or maintain pricing at uncompetitive levels resulting in consumer welfare loss.

3.11 However, further market entry could be undermined by a stringent charge control. The benefits of widespread LLU-based competition are clear. Consumers enjoy more choice, lower pricing and better products than in markets where LLU operators are not present. These product and pricing differences can only be partially explained by diminished scale and scope economies in less densely populated exchanges (not least because where LLU operators have entered Market 2 they typically offer the same retail broadband services as they do in Market 3).

3.12 Therefore, when deciding what is appropriate in terms of regulatory pricing constraint in Market 2, a balance must be struck between the static efficiencies derived from protecting consumers and CPs from high, monopoly pricing while allowing dynamic efficiencies to flow from market entry and investment in the form of increased competition and innovation.

3.13 The Market 2 conditions cited in paragraph 2.3 above - namely, high wholesale and retail prices, relatively poor product functionality – have occurred despite BT's voluntary pricing commitments.[6] Furthermore, BT's Return on Capital Employed across the WBA market nationally has grown from 1.8% in 2004/5 to 34.8% in 2008/9[7]. This is despite increased competition resulting in a loss of scale and scope economies for BT in Market 3.

3.14 Given these high returns and the lack of effective constraint exerted by the limited Market 2 entry thus far, a cost orientation condition, at a minimum, would be a proportionate remedy in Market 2.

3.15 The scope of any regulatory pricing constraint will need to be applied so that all relevant wholesale broadband access services are covered. A cost orientation condition that is applied to each and every individual charge will help avoid scope for market

[5] TalkTalk have recently announced plans to extend its LLU footprint to 2,000 exchanges. Sky is also unbundling more exchanges.
[6] As such, regulatory pricing constraint that is weaker than the voluntary commitments could result in further static efficiency loss.

[7] Table 4.3, page 72 *"Review of the Wholesale Broadband Access Markets"*

distorting pricing. In our view, the scope of relevant services is quite broad and should include essential services like migrations, ceases and access to BT's Broadband Speed Availability Checker (BBAC).

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