

Reference under section 193 of the Communications Act 2003

**British Telecommunications plc
v Office of Communications**

Case 1238/3/3/15

**TalkTalk Telecom Group plc
v Office of Communications**

Case 1237/3/3/15

Final determination

Notified: 13 June 2016

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Excisions in this determination marked with [✂] relate to commercially confidential information: Schedule 4, paragraph 1, to the Enterprise Act 2002.

Contents

Page

Final determination.....	5
1. Introduction	5
Background to the appeals	6
The Final Statement.....	8
Description of the Margin Condition	10
2. The appeals	12
The CAT’s judgment on the non-specified price control matters.....	15
The legal framework	16
Standard of review	18
Materiality	24
Our process	26
3. The structure of our determination	27
Approach to the BT Appeal.....	27
The design of the test	28
Static approach.....	29
BT Sport	29
Legal and regulatory principles.....	30
BT’s reponse to our provisional determination.....	30
Approach to the TalkTalk appeal	33
4. BT Appeal: The design of the test.....	33
Introduction	33
Reference questions 3(a), 3(b), 3(e) and 4(d): Alleged restrictive nature of the test.....	35
Ofcom’s approach	36
BT’s case.....	40
Our assessment of reference questions 3(a), 3(b), 3(c) and 4(d): The alleged restrictive nature of the test.....	44
Our determination on reference questions 3(a), 3(b), 3(e) and 4(d): Alleged restrictive nature of the test	54
Reference questions 3(d) and 4(b): Average customer life.....	56
Ofcom’s approach	57
BT’s case.....	59
Our assessment of reference question 3(d) and 4(b): Average customer life.....	61
Our determination on reference questions 3(d) and 4(b): Average customer life.....	73
5. BT Appeal: Reference questions 3(c), 4(a) and 5(a): Static approach.....	73
Ofcom’s approach	74
BT’s case.....	78
Our assessment of reference questions 3(c), 4(a) and 5(a): Static approach	79
Our determination on reference questions 3(c), 4(a) and 5(a): Static approach	88
6. BT Appeal: Reference questions 3(f), 3(g), 3(j), 4(c), 5(b), 3(h), 4(h) and 5(c): BT Sport	89
Introduction	89
Ofcom’s general approach.....	90
Reference question 3(f): Treatment of BT Sport costs.....	94
BT’s case.....	94

Our assessment of reference question 3(f): Treatment of BT Sport costs	98
Our determination on reference question 3(f): Treatment of BT Sport costs	113
Reference question 3(g): Costs of entry	113
BT's case	113
Our assessment of reference question 3(g): Costs of entry	115
Our determination on reference question 3(g): Costs of entry	127
Reference question 4(c): LRIC+ applied to BT Sport	127
Reference question 3(j): Treatment of BT Sport launch costs and marketing costs	128
Launch costs	128
Marketing costs	132
Our determination on reference question 3(j): Treatment of BT launch costs and marketing costs	135
Reference questions 3(i) and 5(b): The value-based approach	135
Ofcom's approach	136
BT's case	136
Our assessment of reference questions 3(i) and 5(b): The value-based approach	138
Our determination on reference questions 3(i) and 5(b): The value-based approach	143
Reference questions 3(h), 4(h) and 5(c) - the Pay TV approach	143
Background to the Pay TV approach	144
BT's case	145
Our assessment of reference questions 3(h), 4(h) and 5(c): the Pay TV approach	147
Our determination on reference questions 3(h), 4(h) and 5(c): the Pay TV approach	149
7. BT Appeal: Legal and regulatory principles	149
Reference question 4(e): Objective justification and proportionality	150
BT's case	150
Our assessment of reference question 4(e): Objective justification and proportionality	151
Our determination on reference question 4(e): Objective justification and proportionality	152
Reference question 4(f): Promotion of competition, efficiency or consumer benefits	152
BT's case	153
Our assessment of reference question 4(f): Promotion of competition, efficiency or consumer benefits	153
Our determination on reference question 4(f): Promotion of competition, efficiency or consumer benefits	155
Reference question 4(g): BT's investment	155
Ofcom's approach	155
BT's case	156
Our assessment of reference question 4(g): BT's investment	157
Our determination on reference question 4(g): BT's investment	158
Reference question 1: Utmost Account	158
Legal framework	159
Background	160
BT's case	162
Our assessment of reference question 1: Utmost account	163

Our determination on reference question 1: Utmost account	165
Reference questions 2 and 4(i): Legal certainty and transparency	165
Introduction.....	165
Ofcom’s approach	165
BT’s case.....	167
Our assessment of reference questions 2 and 4(i): Legal certainty and transparency.....	169
Our determination on reference questions 2 and 4(i): Legal certainty and transparency.....	176
8. BT Appeal: Assessment of Remedy	176
Introduction	176
Our process for considering remedies	177
Proposed design of the remedy	177
Proposed approach to implementation	178
The proposed remedy.....	179
Length of compliance period.....	179
Our conclusion on the proposed remedy.....	190
BT’s alternative treatment of the net cost of BT Sport	190
Continued provision of product-level data	193
Our assessment	193
Dates of compliance period	193
Conclusion.....	196
9. TalkTalk appeal: Reference question 1 – A product-level test.....	196
Introduction.....	196
Ofcom’s approach	196
TalkTalk’s case.....	198
Our assessment of reference question 1: A product-level test	202
Our determination on reference question 1: A product-level test.....	217
10. TalkTalk Appeal: Reference question 2: Call revenues	217
Introduction.....	217
Ofcom’s approach	218
TalkTalk’s case.....	220
Our assessment of reference question 2: Call revenues	223
Our determination on reference question 2: Call revenues	231
11. Determination	232
BT Appeal	232
TalkTalk Appeal	232

Appendices

- A: BT Appeal, Reference to the CMA
- B: TalkTalk Appeal, Reference to the CMA
- C: Draft VULA Margin Condition
- D: Revised VULA Margin Guidance

Glossary

Final determination

1. Introduction

- 1.1 Since 2010, British Telecommunications plc (BT) has been required to provide wholesale access to its fibre network to other communication providers (CPs) to enable them to compete with BT in the retail of superfast broadband (SFBB) to consumers. This access is provided through a wholesale product known as VULA (Virtual Unbundled Local Access).
- 1.2 On 19 March 2015, the Office of Communications (Ofcom), in exercise of its statutory obligations, imposed a price condition on BT in relation to its wholesale access to VULA. The condition requires BT to maintain a minimum margin between the wholesale price it charges for access to the SFBB network and its retail price. It is known as the VULA Margin Condition ('the Margin Condition' or 'the Price Control').
- 1.3 Ofcom published the details of, and gave effect to, the Margin Condition in its 'Fixed Access Market Reviews: Approach to the VULA margin' ('the Final Statement'),¹ taken pursuant to section 87(9) and section 88(1)(a) of the Communications Act 2003 (the Act). The Act also implements in the UK the regulation of the telecommunications sector under the Common Regulatory Framework ('the CRF') which applies across the European Union.
- 1.4 BT and TalkTalk Telecom Group plc (TalkTalk) lodged appeals under section 192 of the Act against the decision contained in Ofcom's Final Statement. The Competition Appeal Tribunal (CAT) referred a number of specified price control matters to the Competition and Market Authority (CMA) for determination, in accordance with section 193 of the Act.²
- 1.5 This document sets out our determination of the specified price control matters in both appeals.
- 1.6 In this section, we provide a brief background to the appeals and a description of the Margin Condition. In Section 2, we set out the legal basis of the two appeals and the relevant legal framework applicable to both. In Section 3, we describe the structure of the remainder of this determination and our approach to answering the reference questions in each of the appeals.
- 1.7 Sections 4 to 7 consider BT's Appeal reference questions and Sections 8 and 9 consider TalkTalk's Appeal reference questions. In each section, we

¹ [Final Statement](#), 19 March 2015.

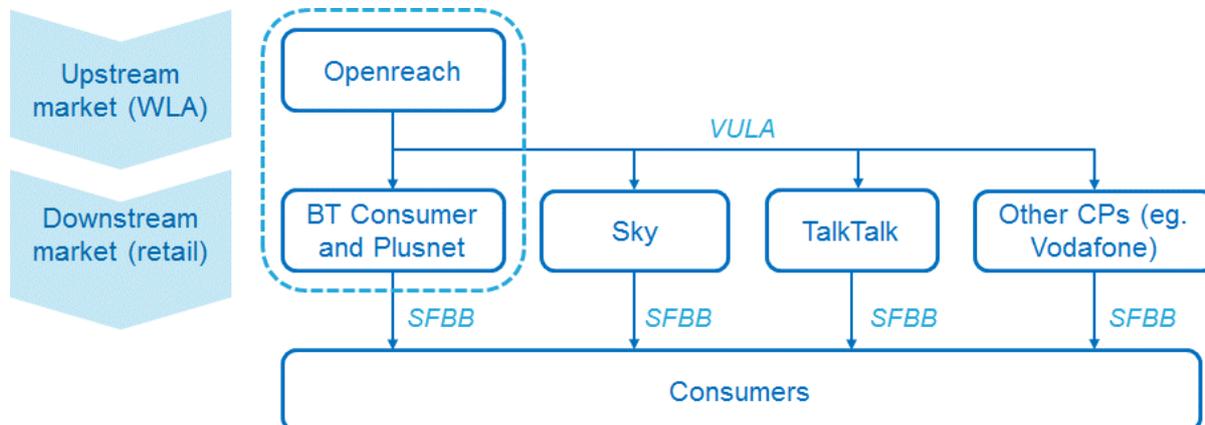
² Orders of the CAT, 5 January 2016, which set out the reference questions to be determined by the CMA in each of the appeals. These can be found at Appendix A and Appendix B.

summarise the relevant main arguments and supporting evidence put forward by the parties in relation to each reference question; assess those arguments and set out our determination on the reference question; and, where relevant, set out our remedy to correct the error identified.

Background to the appeals

- 1.8 BT has a standard broadband (SBB) network based on traditional copper wiring. Its next generation access (NGA) network uses fibre broadband and offers faster speeds. This is referred to as SFBB.
- 1.9 BT's wholesale division (Openreach) is required to grant other CPs access to its fibre broadband network through its wholesale VULA product.³ This enables those CPs to supply SFBB to consumers using BT's wholesale network and compete with BT and each other in the provision of SFBB. VULA is needed as an input into retail SFBB products offered by other CPs such as British Sky Broadcasting Limited (Sky) and TalkTalk, and by BT's own retail businesses (BT Consumer and Plusnet) (see Figure 1 below). Virgin Media has its own cable network, and it does not provide other CPs with access to this network. Therefore, in those areas covered by its network, Virgin Media competes for SFBB customers with BT, and other CPs using BT's network.

Figure 1: Schematic supply chain of SFBB



Source: CMA.

³ VULA provides access to BT's NGA network which offers faster connection speeds required for SFBB. Rather than providing a physical line, VULA provides a virtual connection that gives CPs a direct link to their customers and provides flexibility over how this link is integrated into their network and product offerings. The requirement on BT to provide VULA was imposed by Ofcom in its 2010 Wholesale Local Access (WLA) Statement ('the 2010 WLA Statement').

- 1.10 The Margin Condition forms part of the overall suite of remedies imposed on BT by Ofcom to address BT's significant market power (SMP) in the WLA market in the UK, excluding the Hull area.
- 1.11 In the 2010 WLA Statement, Ofcom required BT to provide wholesale access to its new fibre broadband network, in the form of VULA, on: (a) fair and reasonable terms, conditions and charges; and (b) an equivalence of inputs basis.⁴ In the 2010 WLA Statement, Ofcom found that it was appropriate to define a single market for broadband services at all speeds and defined a single retail product market including fibre, cable and copper-based products at all speeds.⁵
- 1.12 In its 26 June 2014 Fixed Access Market Review Statement ('the 2014 FAMR Statement'), which covers the 2014 to 2017 market review period, Ofcom found that BT had SMP in the market for the supply of loop-based, cable-based and fibre-based wholesale local access at a fixed location in the UK excluding the Hull Area.⁶ The 2014 FAMR Statement went on to impose SMP conditions on BT, including an obligation to offer to supply VULA on fair, reasonable and non-discriminatory terms, conditions and charges ('the FRAND obligation')⁷ and an obligation to provide network access on an equivalence of inputs basis. Ofcom also explained that it is was appropriate to continue to define a single retail market for all broadband speeds.⁸
- 1.13 The 2014 FAMR Statement also set out Ofcom's view that it was not appropriate to regulate the absolute level of the VULA wholesale charge. Ofcom decided that in addition to imposing the FRAND obligation, it would also impose a stand-alone VULA Margin Condition on which it would consult separately. This obligation would require BT to maintain a sufficient margin between its wholesale VULA price and its retail charges for SFBB, to ensure that BT could not use its SMP in the WLA market to distort retail competition in SFBB.
- 1.14 Ofcom consulted on its proposals to impose a Margin Condition on 19 June 2014 ('the Consultation'). On 15 January 2015, it notified the European Commission ('the Commission') of its draft proposals, in accordance with its

⁴ Equivalence of inputs is a process where the inputs available to all CPs, including BT's downstream divisions, would be provided on a truly equivalent basis ie on identical terms

⁵ In its statement entitled 'Review of the wholesale broadband access markets Statement on market definition, market power determinations and remedies' in 2014, Ofcom considered that it was still appropriate to define a single market for broadband services at all speeds: see paragraph 3.71.

⁶ As part of its decision in the Final Statement, Ofcom undertook an assessment to identify whether there had been a material change to its determination that BT has SMP in the WLA market since publication of the 2014 FAMR Statement. It was satisfied that there had been no material change.

⁷ This built on similar fair and reasonable obligations first imposed on BT as part of its 2010 WLA Statement.

⁸ The 2014 FAMR Statement, paragraph 7.45.

obligations under the Framework Directive, and received comments from the Commission in a letter dated 13 February 2015 ('the Commission's Comments').⁹ Ofcom published its Final Statement on 19 March 2015 which included, in Annex 2, the legal instrument imposing the Margin Condition ('the Legal Instrument') and, in Annex 3, 'Guidance on the assessment of the VULA margin' ('the Guidance'). The Margin Condition came into effect on 1 April 2015 and will be in place to the end of the review period in March 2017.

- 1.15 In June 2015, BT announced changes to its BT Sport product resulting from its rights to broadcast UEFA football from August 2015. Ofcom considered that these changes constituted a material change of circumstances. Therefore, after having consulted on its approach, Ofcom published its 'Supplementary Guidance on assessment of the VULA margin' on 13 August 2015 ('the Supplementary Guidance').¹⁰ The Supplementary Guidance set out the approach Ofcom would take to the assessment of the minimum margin during the launch period of BT's UEFA channels.

The Final Statement

- 1.16 Section 2 of the Final Statement set out, among other things: (a) the purpose of the Final Statement, and (b) the Final Statement's relationship with the 2014 FAMR Statement. In particular, it provided Ofcom's assessment on whether there have been any changes to the WLA market in the UK (excluding the Hull area) since the FAMR's publication that would falsify to a material extent the forecasts made in the market analysis set out in the 2014 FAMR Statement.¹¹
- 1.17 Section 3 of the Final Statement explained why Ofcom considered, against the background of the legal framework and in light of its market analysis, that there is a relevant risk of adverse effects arising from price distortion in that BT might so impose a price squeeze as to have adverse consequences for end users of public electronic communications services.¹²
- 1.18 Ofcom concluded the following:
- (a) BT has the ability to impose a price squeeze by reason of its SMP in the WLA market.¹³

⁹ [European Commission letter to Ofcom](#).

¹⁰ Supplementary Guidance.

¹¹ [Final Statement](#), paragraphs 2.9–2.17. See also footnote 6 above.

¹² [Final Statement](#), paragraph 3.6.

¹³ [Final Statement](#), paragraphs 3.60–3.63.

- (b) There is a 'significant and real risk' that BT has the incentive to impose a price squeeze based on the immediate and long term competitive advantages (marketing, enhanced scale and weakened competitive pressure) that BT could gain in the expanding the SFBB segment from raising its rivals' costs and deterring their future investment in that segment.¹⁴
- (c) Risk is not removed by any other factor in the market. Specifically, Ofcom rejected BT's representations that either existing legal and regulatory constraints or prospects for increased competition would have that effect.¹⁵
- (d) Any price squeeze by BT would have adverse consequences for users in a number of respects within and beyond the period under review:¹⁶ (i) competitive pressures would diminish to the detriment of consumers in terms of price and a range of non-price factors; and (ii) consumer choice and innovation would both be reduced. Such conduct could, furthermore, indicate BT's willingness to punish rivals that compete too aggressively, leading to a further weakening of competitive pressures with similar effects to those already noted.

1.19 Having reached those conclusions, Ofcom explained that its regulatory aim:

...is to address this risk: that is, to promote competition by ensuring that BT cannot use its SMP in the WLA market to set the VULA margin over the period of the market review such that it causes retail competition in SFBB to be distorted by virtue of imposing a price squeeze which has adverse consequences for end users of public electronic communications and services.¹⁷

1.20 Section 4 considered whether, in light of Ofcom's regulatory aim, it was appropriate to impose some form of regulation to control the VULA margin. Ofcom first considered whether competition law is sufficient to address its aim and then set out its conceptual approach to *ex ante* margin regulation.

1.21 Section 5 set out the detail of the VULA margin assessment; Section 6 discussed the treatment of costs and revenues; and Section 7 set out Ofcom's overall conclusions.

¹⁴ [Final Statement](#), paragraphs 3.64–3.76.

¹⁵ [Final Statement](#), paragraphs 3.77–3.82 and Section 4.

¹⁶ [Final Statement](#), paragraphs 3.83–3.89.

¹⁷ [Final Statement](#), paragraph 3.93.

Description of the Margin Condition

- 1.22 In this section we set out a brief overview of the Margin Condition and how it works. More detail on the different components of the Margin Condition are covered as necessary in subsequent sections assessing the various reference questions to be determined by the CMA.
- 1.23 Ofcom described its regulatory aim in setting the Margin Condition as being ‘to ensure that BT cannot use its SMP in the WLA market to set the VULA margin over the period of the market review such that it causes retail competition in superfast broadband to be distorted’.¹⁸ Ofcom went on to conclude that the most appropriate and proportionate measure to impose on BT to achieve its aim was an SMP condition which required BT to set the VULA charge so as to maintain a minimum differential between the wholesale VULA price and the price of the retail packages offered by BT that use VULA as an input.¹⁹
- 1.24 In broad terms, the Margin Condition put in place by Ofcom:
- (a) is based on an adjusted equally efficient operator (EEO) approach which uses BT’s own costs and revenues (with two adjustments).²⁰ The adjusted EEO approach aims to reflect an operator that has slightly higher costs than BT, or some other slight commercial drawback relative to BT;
 - (b) uses a LRIC+ standard (ie long-run incremental cost plus a contribution to fixed and common costs) to assess BT’s costs;
 - (c) is based on an assessment of BT Consumer’s portfolio of fibre-based packages rather than individual products or bundles; and
 - (d) includes all costs and revenues bundled with SFBB, including BT Sport (generally bundled for free with SFBB) and BT TV.²¹
- 1.25 In its Final Statement, Ofcom provided a stylised illustration of a minimum VULA margin, setting out the relationship between a vertically integrated firm (with both upstream and downstream arms) and a retail, downstream only rival.

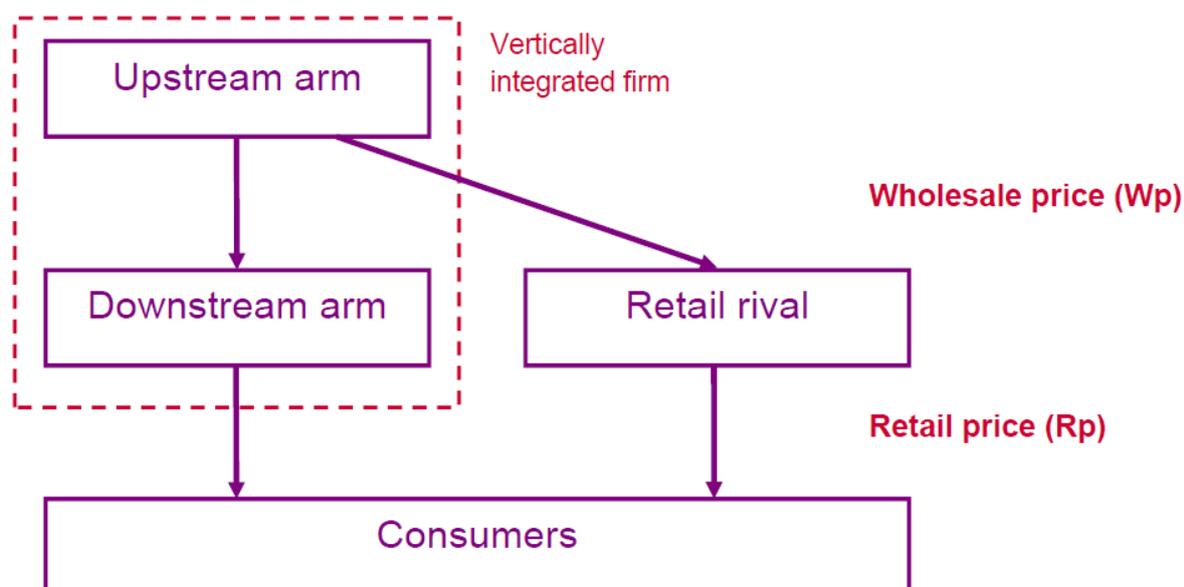
¹⁸ [Final Statement](#), paragraph 5.3.

¹⁹ [Final Statement](#), paragraph 4.115.

²⁰ Ofcom adjusted to a lower average customer lifetime (ACL) and bandwidth costs where Ofcom included a floor on the unit bandwidth costs used in the assessment, effectively adjusting these BT costs in certain circumstances.

²¹ [Final Statement](#), paragraphs 5.104–5.110. Bundles that offer voice, broadband and TV services are generally known as ‘triple play’ bundles. Ofcom found that triple play was becoming increasingly important in the sector.

Figure 2: Illustration of a minimum VULA margin

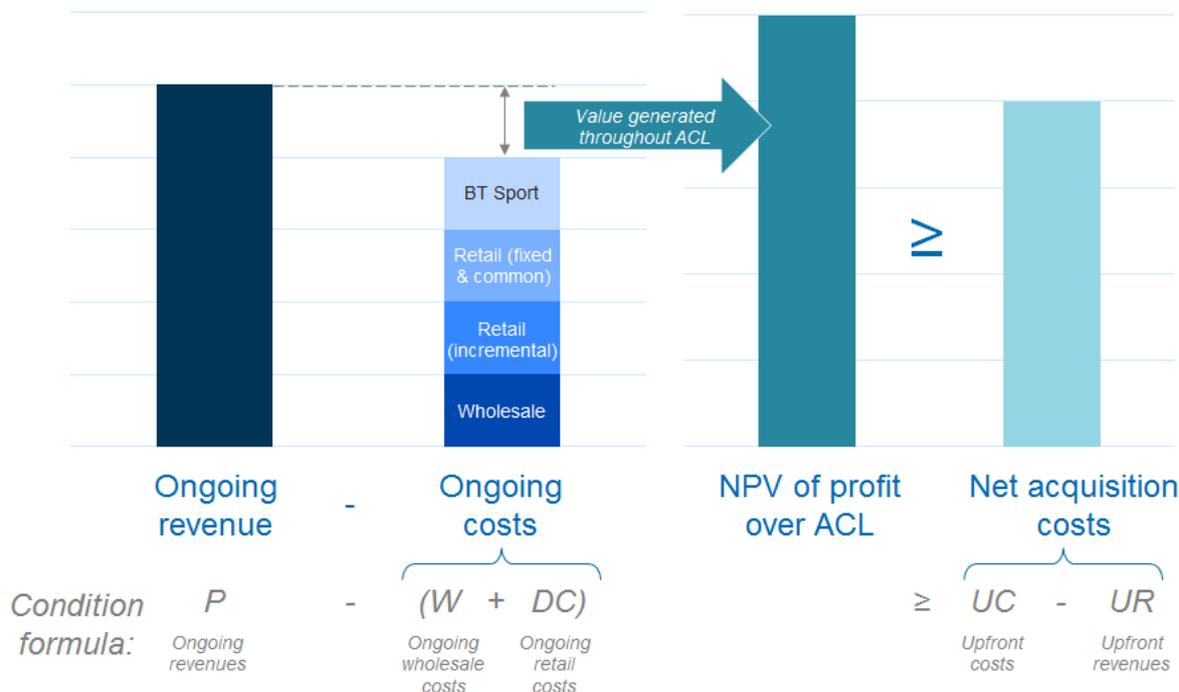


Source: Ofcom.

- 1.26 The Margin Condition sets a minimum margin requirement for each newly acquired cohort of BT's SFBB customers. This cohort includes both customers entirely new to BT and those upgrading from BT's other services, such as SBB. As set out below, the Margin Condition is based on ensuring that the net acquisition costs and ongoing costs are fully recovered for each cohort over across their expected lifetimes (or Average Customer Lifetime (ACL)) with BT.
- 1.27 The Margin Condition is based on a relative assessment of the following:
- (a) **Ongoing revenue** – Average prices for customers' bundles, including line rental, and any additional chargeable items (eg out-of-package phone calls).
 - (b) **Ongoing costs (LRIC+)** – The wholesale and retail costs of serving the customer. This includes both a share of fixed and common costs (eg core network costs), and a share of the net costs of BT Sport.
 - (c) **Net acquisition costs** – The cost to acquire an average SFBB customer, including marketing, equipment for their home (eg a router), and the cost of connecting them to the Openreach fibre network. The price paid by new customers in their initial contract period is usually less than the average price paid by others and the difference (initial discount) is treated as an acquisition cost. The acquisition costs are net of any upfront revenue, such as connection charges.

1.28 As illustrated in Figure 3, BT is compliant with the Margin Condition as long as the net present value of the surplus of ongoing revenue over cost²² exceeds the net acquisition cost for the relevant cohort of SFBB customers. Ofcom has, in general, assumed that costs and revenues for a particular cohort do not change during the ACL. Any excess value generated by the customer is referred to as BT's 'headroom' on the test.

Figure 3: Margin Condition assessment



Source: CMA.

1.29 Ofcom collects the data required to complete this test every six months (the assessment period). It is analysed for each individual month separately (the compliance period). BT must therefore demonstrate that it earns the required level of margin (ie the headroom is positive) in each monthly compliance period in order to pass the test. This results in a pass/fail test based on the numbers, which BT refers to as the 'bright-line' nature of the test.

2. The appeals

2.1 The Act provides a specific regime for appeals relating to price controls imposed by Ofcom.

2.2 Section 192(2) of the Act provides that a person affected by a decision to which section 192 applies may appeal against it to the CAT.

²² Discounted at BT's Weighted Average Cost of Capital.

- 2.3 Section 192(6) specifies the grounds on which an appeal may be brought under section 192(2). These are that Ofcom's decision was based on an error of fact or was wrong in law, or both, or an erroneous exercise of discretion by Ofcom.
- 2.4 Sections 193 to 195 of the 2003 Act then set out the procedure to be followed in appeals brought under section 192(2). Broadly those provisions require the CAT to identify whether and to what extent an appeal raises 'price control matters'.²³
- 2.5 To the extent that an appeal raises specified price control matters,²⁴ those matters must be referred by the CAT to the CMA by way of reference questions for the CMA to determine. Matters which are not specified price control matters are to be decided by the CAT.
- 2.6 Once the CMA has notified the CAT of its determination of the specified price control matters referred to it, the CAT must decide the appeal on the merits. It must decide the specified price control matters in accordance with the determination of the CMA, unless the CAT decides, applying the principles applicable on an application for judicial review, that the CMA's determination would fall to be set aside on such an application.
- 2.7 On 19 May 2015, the CAT gave notice of the receipt of appeals by BT ('the BT Appeal')²⁵ and TalkTalk ('the TalkTalk Appeal')²⁶ against Ofcom's decision contained in the Final Statement. The CAT subsequently granted permission for Sky and TalkTalk to intervene in the BT Appeal and for BT to intervene in the TalkTalk Appeal.²⁷
- 2.8 In a Ruling dated 29 June 2015, the CAT classified which of the parties' grounds of appeal raised specified price control matters and would be referred to the CMA for determination, and which did not.²⁸
- 2.9 The CAT ruled that Ground 1 and 5(A) of BT's original Notice of Appeal were not specified price control matters, as they went to the question of whether

²³ [Section 193\(9\)-\(10\)](#) of the Act.

²⁴ A 'specified price control matter' is defined in rule 2, read together with rule 116(1) of the Competition Appeal Tribunal Rules 2015, which came into force on 1 October 2015. The rules which were in force prior to 1 October 2015 were the Competition Appeal Tribunal (Amendment and Communications Act Appeals) Rules 2004 (the 2004 Rules).

²⁵ [Case number 1238/3/3/15](#).

²⁶ [Case number 1237/3/3/15](#).

²⁷ [Order of the CAT](#), 17 July 2015.

²⁸ [Ruling of the CAT \(Case Management\)](#), 29 June 2015.

Ofcom was justified in imposing any price control at all. These grounds are in summary:

- (a) **Ground 1** – Ofcom’s decision in its Final Statement failed to make out a ‘relevant risk of adverse effects arising from price distortion’ for the purposes of sections 88(1)(a) and 87(9) of the Act on the basis that (i) its market analysis was wholly inadequate and based on an error of law; and (ii) it had failed to give any or any sufficient weight to constraints of competition law and/or historic evidence of BT’s conduct since 2010.
- (b) **Ground 5(A)** – Ofcom was wrong to consider that any additional regulation was required beyond the existing regulation maintained under the 2014 FAMR.

2.10 There was no disagreement that Ground 1 was a non-specified price control matter that would fall to be determined by the CAT, but there was dispute in relation to Ground 5(A). Since this is material to the scope of the questions referred to us, we set out below the CAT’s reasoning in relation to Ground 5(A).²⁹ Under this ground, BT contended that Ofcom was wrong to consider that any additional regulation was required beyond that already in existence. The CAT decided that Ground 5(A) should also be categorised as a non-specified price control matter that it would determine. In its ruling, the CAT held as follows:

- 41. The debate over the classification of Ground 5A highlights the potential overlap between specified and non-specified PCMs [price control matters] and the need to analyse closely both the nature and context of an appellant’s case in order to determine on which side of the line a ground of appeal falls. BT submits that Ground 5A (like Ground 6) raises an issue of proportionality, calling into question whether the regulatory status quo, including the fair and reasonable condition imposed by the Fixed Asset Market Review 2014 (the ‘FRAND measure’), is a sufficient form of price control. It contends that that question of proportionality is a matter of design and that Ground 5A therefore raises a specified PCM.
- 42. We accept that, if there were no existing FRAND measure and BT’s complaint was that Ofcom had erred in imposing the Condition rather than the FRAND measure, that would

²⁹ See paragraph 3.14 below.

be a design question raising a specified PCM. In that context, the prior question would be as to whether there was a need for any price control at all (a non-specified PCM): but, in view of BT's acceptance of the need for the FRAND measure, that question would not be raised. In the present context, the prior question is (as the CMA submitted) whether, given the existence of the FRAND measure, there is an outstanding problem that needs to be remedied by an enhanced price control. Ground 5A essentially raises that question and is therefore not a specified PCM.³⁰

- 2.11 Accordingly, Ground 1 and Ground 5A of the BT Appeal were to be determined by the CAT.³¹ The CAT concluded that the remainder of the BT Appeal was to be referred to the CMA for determination.
- 2.12 In the TalkTalk Appeal, the CAT ruled that both of its grounds of appeal³² raise specified price control matters and that they should therefore be referred to the CMA for determination.³³
- 2.13 By Orders dated 5 January 2016, the CAT referred to the CMA a number of reference questions to be determined in each appeal.³⁴
- 2.14 In both appeals, the CAT directed that the CMA must determine the issues which have been referred to it by 5 July 2016 and must notify the parties to the appeal of its determination at the same time as it notifies the CAT.³⁵

The CAT's judgment on the non-specified price control matters

- 2.15 The CAT considered five issues raised by BT's in its appeal on the non-specified price control matters. These were:
- (a) whether Ofcom adopted the wrong approach to the assessment of relevant risk of adverse effects arising from a price squeeze;
 - (b) whether Ofcom erred in law by failing to take account in its market analysis of legal and regulatory constraints affecting BT;

³⁰ *British Telecommunications v Ofcom* [2015] CAT 13, paragraph 42.

³¹ In light of the CAT's ruling, BT amended its original Notice of Appeal so that Ground 1 incorporated the issues previously raised under Ground 5(A).

³² TalkTalk challenges Ofcom's decision not to conduct a product-level test (Ground 1) and Ofcom's treatment of call revenues in the Margin Condition (Ground 2).

³³ [Ruling of the CAT \(Case Management\)](#), 29 June 2015.

³⁴ Copies of these Orders can be found at Appendix A and Appendix B.

³⁵ See paragraphs 4 & 5 of the Orders of the CAT dated 5 January 2016 (see Appendix A and Appendix B).

- (c) whether Ofcom failed to give sufficient weight to existing legal and regulatory constraints;
- (d) whether Ofcom was wrong to consider that additional regulation was required beyond existing regulation; and
- (e) whether Ofcom failed to analyse the prevailing market conditions to the requisite standard.

2.16 The CAT found in favour of Ofcom on all these issues and unanimously dismissed Ground 1 of BT's amended claim.³⁶

The legal framework

2.17 As noted above, regulation of the telecommunications sector takes place across the European Union under the CRF. The CRF consists of a number of Directives, the most relevant of which are:

- (a) Directive 2002/21/EC on the common regulatory framework for electronic communications networks and services (as amended) ('the Framework Directive');³⁷ and
- (b) Directive 2002/19/EC on access to, and interconnection of, electronic communications networks and associated facilities (as amended) ('the Access Directive').³⁸

2.18 The CRF imposes on member states the obligation to designate independent national regulatory authorities (NRAs); sets out objectives and principles that the NRAs are to be guided by in carrying out their functions; obliges them to carry out market reviews; and empowers them to impose certain obligations on undertakings with SMP,³⁹ including price controls.

2.19 The UK's NRA is Ofcom and the CRF was implemented in the UK by the Act, in which the powers and duties set out in the Directives are reflected.

³⁶ See *British Telecommunications plc v Ofcom* [2016] CAT 3.

³⁷ The Framework Directive establishes a harmonised framework for the regulation of electronic communications services and networks and associated facilities and services. It also establishes a set of procedures to ensure the harmonised application of the regulatory framework throughout the Community.

³⁸ The Access Directive harmonises the way in which member states regulate access to, and interconnection of, electronic communications networks and associated facilities. It deals with the imposition of obligations by NRAs on operators designated as having SMP.

³⁹ Pursuant to Article 14(2) of the Framework Directive, an undertaking shall be deemed to have significant market power if, either individually or jointly with others, it enjoys a position equivalent to dominance, that is to say a position of economic strength affording it the power to behave to an appreciable extent independently of competitors, customers and ultimately consumers.

- 2.20 The Act, in line with the CRF, imposes general duties and objectives upon Ofcom, in particular the following:
- (a) Ofcom has a number of general duties, in particular the duty to further the interests of citizens in relation to communications matters and to further the interests of consumers in relevant markets, where appropriate by promoting competition.⁴⁰
 - (b) Ofcom has further duties relating to the fulfilment of its EU obligations, which, insofar as are relevant, include a requirement to promote competition in relation to the provision of electronic communications networks and services; an obligation to encourage the provision of network service and interoperability for the purpose of securing efficient investment and innovation; and a requirement to take account of the desirability of it carrying out its functions in a manner which, so far as practicable, does not favour one form of electronic communications network, service or associated facility over another or one means of providing or making available such a network, service or facility over another.⁴¹
 - (c) Ofcom must take due account of all applicable recommendations issued by the Commission under the Framework Directive.⁴²
 - (d) Ofcom has the power to set binding conditions, including SMP conditions.⁴³ An SMP condition can be applied to a CP that Ofcom has determined as having SMP in a specific market,⁴⁴ but only if Ofcom is satisfied that the condition is:
 - (i) objectively justifiable in relation to the networks, services, facilities, apparatus or directories to which it relates;
 - (ii) not such as to discriminate unduly against particular persons or against a particular description of persons;
 - (iii) proportionate to what it is intended to achieve; and
 - (iv) in relation to what it is intended to achieve, transparent.⁴⁵
 - (e) Ofcom has a specific power to set SMP conditions that impose price

⁴⁰ [Section 3 of the Act.](#)

⁴¹ [Section 4 of the Act.](#)

⁴² [Section 4A of the Act.](#)

⁴³ [Section 45 of the Act](#)

⁴⁴ [Section 46\(7\)–\(8\) of the Act.](#)

⁴⁵ [Section 47 of the Act.](#)

controls.⁴⁶ The imposition of price controls is subject to section 88 which provides:

88. Conditions about network access pricing etc.

- (1) OFCOM are not to set an SMP condition falling within section 87(9) except where—
 - (a) it appears to them from the market analysis carried out for the purpose of setting that condition that there is a relevant risk of adverse effects arising from price distortion; and
 - (b) it appears to them that the setting of the condition is appropriate for the purposes of—
 - (i) promoting efficiency;
 - (ii) promoting sustainable competition; and
 - (iii) conferring the greatest possible benefits on the end-users of public electronic communications services.
- (2) In setting an SMP condition falling within section 87(9), OFCOM must take account of the extent of the investment in the matters to which the condition relates of the person to whom it is to apply.

2.21 In assessing each of the reference questions we have had regard to the CRF and the domestic provisions implementing it. We consider our determination to be consistent with the legal framework.

Standard of review

2.22 Pursuant to section 195(2) of the Act, the CAT must decide an appeal brought under section 192 on the merits and by reference to the grounds of appeal set out in the notice of appeal.

2.23 Since the CAT must follow the CMA's determination on specified price control matters referred to it under section 193, the CMA must also determine appeals on the merits and by reference to the grounds of appeal.

2.24 In *TalkTalk v Ofcom*,⁴⁷ the CAT noted that the appropriate level of scrutiny in such appeals was 'profound and rigorous' and added that 'the question is

⁴⁶ [Section 87\(9\) of the Act](#).

⁴⁷ *TalkTalk v Ofcom* [2012] CAT 1 paragraphs 71 & 72.

whether Ofcom's determination was right, not whether it lies within the range of reasonable responses for a regulator to take'.

2.25 A number of our previous determinations of price control references, including those made by the CMA's predecessor the Competition Commission (CC), have outlined the nature of our appellate function under the Act.⁴⁸ We have followed the same approach as in those cases, in particular as summarised in paragraphs 1.30 to 1.33 of the *Mobile Call Termination Determination (MCT)(1)*:

1.30 Section 195(2) of the 2003 Act provides for an appeal on the merits. Section 192(6) shows that appeals can be brought on the basis of errors of fact or law or against the exercise of discretion. The Tribunal interpreted its role under a section 192 appeal as being one of a specialist court designed to be able to scrutinize the detail of regulatory decisions in a profound and rigorous manner. In our view, our role in determining the specified price control matters that have been referred to us is similar...

1.31 We also note that the wording of rule 3 of the 2004 Rules envisages a determination of disputes that relate to the principles or methods applied or the calculations or data used in determining a price control, as well as disputes that relate to what the provisions imposing the price control should be (including at what level the price control should be set). That also suggests a rigorous and detailed examination of the price control matters subject to appeal.

1.32 We have carried out that examination with the purpose of determining whether Ofcom erred for any of the specific reasons put forward by the parties. In determining whether it did so err, we have not held Ofcom to be wrong simply because we considered there to be some error in its reasoning on a particular point – the error in reasoning must have been of sufficient importance to vitiate Ofcom's decision on the point in whole or in part.

⁴⁸ For example as set out in: (a) *Mobile Call Termination (MCT)(1)* ([Cases 1083/3/07 and 1085/3/07](#)) 16 January 2009; (b) *Cable and Wireless* ([Case 1112/3/3/09](#)) 30 June 2010; (c) *Carphone Warehouse (LLU)* ([Case 1111/3/3/09](#)) 31 August 2010; (d) *Carphone Warehouse (WLR)*; (e) *Mobile Call Termination (2)* ([Cases 1180-1183/3/3/11](#)) 9 February 2012; (f) *Wholesale Broadband Access Charge Control* ([Case 1187/3/3/11](#)) 11 June 2012; and (g) *LLU/WLR Charge Control* ([Case 1192-1193/3/3/12](#)) 27 March 2013.

1.33 We have also kept in mind the point made by the Interveners that Ofcom is a specialist regulator whose judgement should not be readily dismissed. Where a ground of appeal relates to a claim that Ofcom has made a factual error or an error of calculation, it may be relatively straightforward to determine whether it is well founded. Where, on the other hand, a ground of appeal relates to the broader principles adopted or to an alleged error in the exercise of a discretion, the matter may not be so clear. In a case where there were a number of alternative solutions to a regulatory problem with little to choose between them, we do not think it would be right for us to determine that Ofcom erred simply because it took a course other than the one that we would have taken. On the other hand, if, out of the alternative options, some clearly had more merit than others, it may more easily be said that Ofcom erred if it chose an inferior solution. Which category a particular choice falls within can necessarily only be decided on a case-by-case basis.

2.26 We consider that the above approach is consistent with the case law of the CAT and the Court of Appeal as set out below.

2.27 First, in *T-Mobile (UK) Limited v Office of Communications*,⁴⁹ the Court of Appeal made it clear that the section 192 appeal process is not intended to duplicate, still less, usurp, the functions of Ofcom:

After all it is inconceivable that Article 4 [of the Framework Directive], in requiring an appeal which can duly take into account the merits, requires Member States to have in effect a fully equipped duplicate regulatory body waiting in the wings just for appeals. What is called for is an appeal body and no more, a body which can look into whether the regulator has got something materially wrong. That may be very difficult if all that is impugned is an overall value judgment based upon competing commercial considerations in the context of a public policy decision.⁵⁰

2.28 Second, as to the meaning of an appeal ‘on the merits’, the CAT stated, in *British Telecommunications plc v Office of Communications*,⁵¹ as follows:

⁴⁹ *T-Mobile (UK) Limited v Office of Communications* [2008] EWCA Civ 1373.

⁵⁰ Judgment, paragraph 31.

⁵¹ *British Telecommunications plc v Office of Communications* [2010] CAT 17.

By section 192(6) of the 2003 Act and rule 8(4)(b) of the 2003 Tribunal Rules, the notice of appeal must set out specifically where it is contended OFCOM went wrong, identifying errors of fact, errors of law and/or the wrong exercise of discretion. The evidence adduced will, obviously, go to support these contentions. What is intended is the very reverse of a *de novo* hearing. OFCOM's decision is reviewed through the prism of the specific errors that are alleged by the appellant. Where no errors are pleaded, the decision to that extent will not be the subject of specific review. What is intended is an appeal on specific points.⁵²

2.29 Third, in *TalkTalk v Ofcom*,⁵³ the CAT said that '[w]here a decision can be challenged by way of a merits appeal, it is incumbent upon an appellant to show – if necessary by way of new evidence – that the original decision was wrong 'on the merits'. It is not enough to suggest that, were more known, the Tribunal's decision might be different'.⁵⁴

2.30 Fourth, as to the standard of review generally we note that the Court of Appeal held in *Everything Everywhere Ltd v Competition Commission*,⁵⁵ as follows:

22. ... If the appellant can do no more than show that there is a 'real risk that the decision was wrong' then it has not shown that Ofcom's decision was wrong and the appeal should be dismissed. But there remains scope for dispute as to what is meant by showing that an original decision is wrong 'on the merits'.

23. It is for an appellant to establish that Ofcom's decision was wrong on one or more of the grounds specified in s.192(6) of the 2003 Act: that the decision was based on an error of fact, or law, or both, or an erroneous exercise of discretion. It is for the appellant to marshal and adduce all the evidence and material on which it relies to show that Ofcom's original decision was wrong. Where, as in this case, the appellant contends that Ofcom ought to have adopted an alternative price control measure, then it is for that appellant to deploy all the evidence and material it considers will support that alternative.

⁵² Judgment, paragraph 76.

⁵³ *TalkTalk v Ofcom* [2012] CAT 1.

⁵⁴ Judgment, paragraph 134.

⁵⁵ *Everything Everywhere Ltd v Competition Commission* [2013] EWCA Civ 154.

24. The appeal is against the decision, not the reasons for the decision. It is not enough to identify some error in reasoning; the appeal can only succeed if the decision cannot stand in the light of that error. If it is to succeed, the appellant must vault two hurdles: first, it must demonstrate that the facts, reasoning or value judgments on which the ultimate decision is based are wrong, and second, it must show that its proposed alternative price control measure should be adopted by the Commission. If the Commission (or Tribunal in a matter unrelated to price control) concludes that the original decision can be supported on a basis other than that on which Ofcom relied, then the appellant will not have shown that the original decision is wrong and will fail.
25. Usually an appellant will succeed by demonstrating the flaws in the original decision and the merits of an alternative solution. But that is not necessarily so. I would not rule out the possibility that there could be a case where an appellant succeeds in so undermining the foundations of a decision that it cannot stand, without establishing what the alternative should be. In such a case, if there is no other basis for maintaining the decision, the Commission or Tribunal would be at liberty to conclude that the original decision was wrong but that it could not say what decision should be substituted. The Tribunal would then be required to allow the appeal under s.195(2) and direct Ofcom to make a fresh decision with such directions as the Tribunal thinks are necessary to reach a properly informed conclusion. The Tribunal may wish to specify the steps to be taken by Ofcom to make good any deficit in evidence and material so as to reach a fresh decision, or leave it to Ofcom to act as it sees fit in the light of the Commission's conclusion.

2.31 Fifth, as to the exercise of Ofcom's regulatory discretion, we note that, in *T-Mobile (UK) Limited v Office of Communications*,⁵⁶ the CAT stated:

It is also common ground that there may, in relation to any particular dispute, be a number of different approaches which OFCOM could reasonably adopt in arriving at its determination.

⁵⁶ *T-Mobile (UK) Limited v Office of Communications* [2008] CAT 12.

There may well be no single ‘right answer’ to the dispute. To that extent, the Tribunal may, whilst still conducting a merits review of the decision, be slow to overturn a decision which is arrived at by an appropriate methodology even if the dissatisfied party can suggest other ways of approaching the case which would also have been reasonable and which might have resulted in a resolution more favourable to its cause.⁵⁷

2.32 Finally, appeals must be determined by reference to the evidence adduced by the parties and that the CMA is not under an investigative duty: see *British Telecommunications plc v Ofcom*,⁵⁸ where the CAT held:

201. The proposition that an administrative decision-maker should ask himself the right question and take reasonable steps to acquaint himself with the relevant information to enable him to answer it correctly is well-established and uncontroversial: see, for example, *Secretary of State for Education and Science v Tameside MBC* [1977] 1 AC 1014 at 1065.
202. It is absolutely clear that when the Commission is exercising its original and investigative jurisdiction, it is under precisely such a duty: see, for example, *Tesco plc v Competition Commission* [2009] CAT 6 at paragraph [139]; *BAA Limited v Competition Commission* [2012] CAT 3 at paragraph [20(3)].
203. In this case, however, the Commission is not exercising any kind of original or investigative jurisdiction. As we made clear in paragraph 118 above, that is the function of OFCOM. The Commission’s role is confined to determining the questions referred to it by the Tribunal. The Commission is not investigating anything – it is determining whether OFCOM erred in its decision for the reasons set out in the notice of appeal. As we noted in paragraph 118 above, the Commission is acting as an administrative appeal body.
204. Accordingly, we hold that the duty on an administrative decision-maker to investigate and seek out the relevant information to enable him to answer the question before him correctly does not apply to the Commission when

⁵⁷ Judgment, paragraph 82.

⁵⁸ *British Telecommunications plc v Office of Communications* [2012] CAT 11.

determining reference questions pursuant to section 193 of the 2003 Act. Rather, the Commission's duty is to discharge its functions under this section in a more judicial manner: it is not investigating with a view to making a decision; it is considering specific complaints about the decision of another. In short, the nature and quality of the scrutiny that the Commission gives to Ofcom's decisions is altogether different (to say 'lower' or 'higher' would be to compare qualitatively different functions) from exercises conducted by the Commission as administrative decision-maker.

- 2.33 The parties to these appeals have made various submissions in relation to the standard of review that should be adopted by us. Generally, the parties accept the principles laid out above and in the CC's previous determinations, although there appears to be some difference in how the principles should be interpreted and the emphasis placed on different aspects, in particular the margin of appreciation to be afforded to Ofcom, as a specialist regulator. However, we do not consider any of the points raised would lead us to depart from the approach that we have previously followed in other determinations and which is broadly summarised above.

Materiality

- 2.34 In determining the reference questions in each of the appeals before us, our task is to identify whether Ofcom's decision has been shown to be materially in error.
- 2.35 In the *Carphone Warehouse* determination,⁵⁹ the CC summarised its approach to the question of materiality as follows:
- 1.58 We considered that our task was to identify whether Ofcom's decision had been shown to be materially in error; in other words, whether any mistakes had a material impact in the context of the price control.
- 1.59 We have not found it possible to set out a general approach to the assessment of materiality; we did not find that such an assessment would be amenable to a formal analytical scheme. Instead, while our approach is broadly similar to that in the CC determinations in *Carphone Warehouse (LLU)* and *Carphone Warehouse (WLR)*, we considered materiality

⁵⁹ *Carphone Warehouse (LLU)* (Case 1111/3/3/09), 31 August 2010.

in the context of the specific facts that arose in these Appeals.

1.60 In each case, we took into account the following factors, none of which we viewed individually as necessarily defining a sufficient condition for materiality:

- (a) the impact of the mistake as a percentage of the relevant charge control; in this context, we noted the CC's determination in Carphone Warehouse (LLU) that where the impact is below 0.1 per cent, the mistake is unlikely to be capable of producing a material effect on the charge control; in those circumstances it fell within an acceptable margin of error for a regulator. In our view, this is not, and was not intended to be, a bright-line test for the assessment of materiality. The impact of the mistake as a percentage of the charge control is but one factor in an overall assessment based on all the circumstances of the case;
- (b) the effort that Ofcom would have had to expend to consider and address fully appellants' criticisms; we noted that this factor may in some instances overlap with the assessment of whether or not it is proportionate for a material error to be corrected;
- (c) persistency, ie whether, if the mistake were not corrected, it would be likely to be repeated or produce effects that persist for longer than the current price control period;
- (d) whether the mistake relates to a matter of economic or regulatory principle;
- (e) whether the mistake has a distortive effect in that it works in different directions or impacts to a different extent on different products or services, thus potentially distorting competition between them;
- (f) the impact of the mistake on any particular companies that are affected if the error is not corrected, and whether this could distort competition between different providers; and

(g) any other factors that may be relevant in the particular context of the issue under consideration.

2.36 We rely on the same approach in considering these appeals.

Our process

2.37 We have conducted these appeals in accordance with the guidance set out in [Price control appeals under section 193 of the Communications Act 2003: Competition Commission Guidelines \(CC13\)](#) as adopted by the CMA ('CC13').⁶⁰

2.38 We held a case management conference on 4 December 2015 with all parties to the appeals to discuss and agree how the appeals would be conducted.

2.39 As mentioned above, on 5 January 2016, the CAT referred the specified price control matters in both appeals to the CMA for determination by 5 July 2016.

2.40 On 8 January 2016, BT delivered a presentation about the technical context of the various products which are the subject of these appeals; and we held a session to understand the modelling used by Ofcom in assessing the Margin Condition and by BT in monitoring compliance with the test.

2.41 On 15 January 2016, we held a core submissions hearing at which the main parties to the appeals, together with the interveners, were invited to make submissions to us on what they considered to be the key aspects of their respective cases. The parties were asked to set out clearly all essential elements of the arguments on which they were relying.

2.42 On 22 January 2016, we received written Core Submissions Volume 1 from all parties, summarising the main arguments presented at the core submissions hearing. Taking into account the opportunity offered by the core submissions hearing, parties were asked to limit their Core Submissions Volume 1 to 20 pages.

2.43 On 1 February 2016, we received written Core Submissions Volume 2 from the appellants to stand as their replies to Ofcom's Defence.

2.44 On 29 February 2016 and 2 March 2016, we held bilateral hearings with BT, Ofcom and Sky to examine in detail their various arguments in relation to the

⁶⁰ We will deal with the issue of costs in accordance with the guidance set out in [Cost recovery in telecoms price control references: Guidance on the CMA's approach \(CMA5\)](#).

reference questions in the BT Appeal. Similarly, on 11 March 2016, we held bilateral hearings with TalkTalk and Ofcom in respect of the TalkTalk Appeal.

- 2.45 On 11 April 2016, we notified to the parties our provisional determination on both appeals and our proposed remedies in respect of the BT Appeal. We invited the parties to submit any comments by 25 April 2016. In this final determination, we have taken into account the parties' comments in response to our provisional determination and have referred to these comments in the relevant sections of this document. In Section 8 we describe further the process we followed to reach our decision on the appropriate remedy for the error we have identified in respect of the BT appeal.

3. The structure of our determination

- 3.1 We first address some general issues raised by BT in response to our provisional determination; then the reference questions referred to us in the BT Appeal; and then those raised in the TalkTalk Appeal. We set out our approach to each appeal below. In both appeals our consideration of each reference question, or groups of questions, is structured in the same way: a summary of Ofcom's approach as set out in its Final Statement on the particular issue or issues challenged; a summary of the appellant's arguments and supporting evidence as set out in its Amended Notice of Appeal and Core Submission Volume 1; our assessment of each of the reference questions drawing, as relevant and necessary, on Ofcom's Defence, the appellant's written submission in reply (as set out in its Core Submission Volume 2), points of intervention and points raised by the parties at the hearings with the CMA; and finally our determination of each reference question.

Approach to the BT Appeal

- 3.2 The specified price control matters referred to the CMA in the BT Appeal comprise six reference questions. Reference questions 3, 4 and 5 are broken down into further sub-questions. As a result, there are 26 separate reference questions that fall to be determined in the BT Appeal. There are clear links between a number of these questions, which BT itself acknowledged in its Core Submissions. In some cases, consideration of one question may be related to or dependent on, to a significant extent, the CMA's view on other questions. In certain reference questions, BT either relies on the same sections of its pleadings or has accepted, in other cases, that certain

reference questions do not raise substantive alternative/additional points to other questions.⁶¹

- 3.3 Having considered the structure and ordering of the reference questions which have been referred to us in the BT Appeal,⁶² we have come to the view that to take the questions in the order set out in the CAT's reference would not provide a coherent and logical consideration of the issues raised in the appeal and the relationship between them. For example, reference question 1 raises a standalone point of law but relies, at least in part, on an assessment of certain decisions contained in the Final Statement which are challenged by BT in reference questions 3 and 4.
- 3.4 We have therefore grouped the reference questions by theme to allow us to consider and assess them in a way that is more logical given the arguments raised by BT in its pleadings. By approaching the reference questions in this way, we have sought to ensure that our determination is structured in a more thematic and coherent way, so as to limit duplication within the document and the amount of cross referencing between various sections.
- 3.5 In the following paragraphs we describe the details of our approach and the order in which we address BT's reference questions. We have assessed BT's reference questions under four main areas, which are:
- (a) the design of the test;
 - (b) the static approach;
 - (c) BT Sport; and
 - (d) legal and regulatory principles.

The design of the test

- 3.6 First, we address those reference questions which allege particular individual flaws in the design of the test which are summarised as follows:
- (a) Reference question 3(a) – the application of a LRIC+ test.
 - (b) Reference question 3(b) – the requirement for a LRIC+ test to be met on a monthly basis.

⁶¹ For instance, BT accepted that: (a) the point on discrimination under reference question 4(h) is 'essentially the same point about regulatory consistency' under reference question 3(h) – see paragraph 6.219 below and BT hearing transcript p125, line 26; and (b) reference question 4(i) raises the same points as those raised in reference question 2 – see paragraph 7.128 below and BT core submission, volume 2, paragraph 278.

⁶² [Order of the CAT](#), 5 January 2016.

- (c) Reference question 3(e) – the application of a pass/fail basis for the test without account of exclusionary intention or effects ('the bright-line test'); and reference question 4(d) – the need for evidence on exclusionary intention or adverse effects.
- (d) Reference questions 3(d) – the ACL assumed in the design of the test; and reference question 4(b) – the application of an adjusted EEO standard.

Static approach

- 3.7 Second, we consider those reference questions which relate to Ofcom's assumption of a constant margin and its decisions not to use forecasts:
- (a) Reference question 3(c) – the application of a static approach.
 - (b) Reference question 4(a) – the decision not to incorporate a prospective analysis.
 - (c) Reference question 5(a) – breach of proportionality having regard to a discounted cash-flow approach and effects-based analysis allowing for the recovery of fixed investment costs over a longer time period.

BT Sport

- 3.8 Third, we consider those reference questions which relate to the inclusion of BT Sport costs in the Margin Condition:
- (a) Reference question 3(f) – the treatment of BT Sport costs; reference question 3(g) – the failure to make an allowance for the long-term costs of entry; and reference question 4(c) – the application of LRIC+ to BT Sport.
 - (b) Reference question 3(j) – the treatment of BT Sport channel launch and marketing costs.
 - (c) Reference question 3(i) – the rejection of the value-based approach; and reference question 5(b) – breach of proportionality having regard to the value approach.
 - (d) Reference question 3(h) - inconsistency with [Ofcom's 31 March 2010 Pay TV statement](#) ('the Pay TV statement'); reference question 4(h) – discrimination when compared to Ofcom's treatment of Sky in the Pay TV statement; and reference question 5(c) – breach of proportionality having regard to the Pay TV statement.

Legal and regulatory principles

- 3.9 Fourth, we assess BT's arguments that Ofcom's approach in introducing the Margin Condition involved errors of principle and/or constituted breaches of EU and/or domestic law. Specifically, we set out our determination on the following:
- (a) Reference question 4(e) – the condition is not objectively justified by, and is disproportionate to, Ofcom's stated aim.
 - (b) Reference question 4(f) – failure to promote efficiency, sustainable competition and/or confer the greatest possible benefits on consumers.
 - (c) Reference question 4(g) – Ofcom's treatment of BT's investment.
 - (d) Reference question 1 – failure to take 'utmost account' of the Recommendations and Comments of the Commission; and
 - (e) Reference question 2 – failure to comply with legal certainty as a general principle of EU law; and reference question 4(i) – failure to impose a regulatory condition which is transparent.
- 3.10 In addressing the questions on legal and regulatory principles, we note that BT relies on a number of the arguments or evidence which it also relies on in relation to the individual design errors it alleges and/or the alternative approaches it proposes. Accordingly, in dealing with these reference questions we draw on our assessment in the earlier sections of BT's criticisms of the design of the test and its alternative approaches. In a number of the reference questions that we address in this section, BT raises few or no additional arguments and/or relies on little or no additional evidence in support. Where this is the case, we address these questions largely by reference to our earlier assessments.

BT's response to our provisional determination

- 3.11 In its response to our provisional determination, BT made a general claim that we had failed to subject the findings of the Final Statement to 'profound and rigorous scrutiny' in a number of significant respects.
- 3.12 BT stated that we failed to consider its claims as to the factual and legal inputs used by Ofcom in exercising its regulatory judgment as amounting to alleged errors of fact or law, but instead had treated them as an appeal against the exercise of Ofcom's discretion.⁶³ In particular, BT submitted that

⁶³ BT response to our provisional determination, paragraph 10(4)–(6).

the onus was on Ofcom to establish the factual basis for 'its intrusive regulation of the relevant market' and not on BT to deploy sufficient alternative evidence on its appeal to allow the CMA to interfere with Ofcom's regulatory discretion.⁶⁴

- 3.13 In determining BT's reference questions, we have had regard to the alleged errors in Ofcom's decision, as set out in BT's pleadings. Accordingly, where BT alleges specific errors of law or fact, we have considered the grounds of appeal on that basis. In so doing, we have reminded ourselves of the Court of Appeal's decision in *Everything Everywhere*, where the court said:

It is for an appellant to establish that Ofcom's decision was wrong on one or more of the grounds specified in s.92(6) of the 2003 Act: that the decision was based on an error of fact, or law, or both, or an erroneous exercise of discretion. It is for the appellant to marshal and adduce all the evidence and material on which it relies to show that Ofcom's original decision was wrong.⁶⁵

- 3.14 However, in circumstances where either (i) BT has not pleaded a specific error of fact or law; or (ii) we have found (in response to a pleaded error) that Ofcom has not erred in law or fact, we have gone on to consider whether Ofcom exercised its discretion in an erroneous way. We consider that this is the correct approach to have taken.
- 3.15 BT also stated that we had given great weight to Ofcom's reasoning and conclusions and had ignored BT's essential complaint that that reasoning and those conclusions were flawed for want of proper evidential basis on the relevant market and/or proper legal analysis of the concept of margin squeeze as defined by the Court of Justice of the European Union (CJEU).⁶⁶ BT raised a further point as to the approach we should have taken to our proportionality analysis of the Margin Condition. In this regard, BT responded that:

- (a) 'the proportionality analysis of the VULA Condition nonetheless depends on the nature and extent of [the relevant] risk, Ofcom's regulatory power extending no further than to ensure that BT cannot use its SMP to cause adverse effects on consumers by imposing a margin squeeze as properly defined in the case law of the CJEU';⁶⁷ and

⁶⁴ BT response to our provisional determination, paragraphs 10(4) & 10(6)(a).

⁶⁵ *Everything Everywhere Limited Appellant v Competition Commission and others* [2013] EWCA Civ 154, paragraph 23, per Moses LJ.

⁶⁶ BT response to our provisional determination, paragraph 10(6)(b).

⁶⁷ BT response to our provisional determination, paragraph 11(1).

- (b) 'it is fundamental to any proportionality analysis of a regulatory measure imposed under Article 8 AD and s. 87 CA 03 that it is based on a sound market analysis of a relevant market as defined in accordance with competition law principles'.⁶⁸
- 3.16 We consider that BT was here rearguing points that it raised in the course of its appeal before the CAT on non-specified price control matters.
- 3.17 Under Ground 1 of its Amended Notice of Appeal, BT argued that there was a lack of a proper evidential basis for Ofcom's findings and/or proper analysis of the concept of margin squeeze. BT correctly identified these matters as amounting to non-specified price control matters. Ground 5(A) of BT's original appeal raised the question of whether, given the existence of the FRAND measure, there was any outstanding problem that needed to be remedied by an enhanced price control. The CAT determined that this latter question was not a specified price control matter to be determined by us, but a matter for it to determine itself.⁶⁹
- 3.18 The CAT found in its judgment of 24 March 2016 (among other things) that (i) Ofcom did not err in its assessment of the relevant market and the competitive constraints on that market;⁷⁰ (ii) the jurisprudence of the CJEU on Article 102 (on abuse of a dominant position) is not determinative of the scope and application of section 88 of the Act;⁷¹ and (iii) that Ofcom had not erred in considering that additional regulation was required beyond that which was already in place.⁷² Specifically, the CAT determined 'that Ofcom was entitled to conclude, in the exercise of its regulatory judgment, that additional regulation was required beyond the regulation existing under the 2014 FAMR Statement'.
- 3.19 In our view, the points raised by BT in response to our provisional determination as to whether the nature and extent of the risk justified the imposition of the Margin Condition, and whether or not the identification of such a risk is based on a 'sound' market analysis, are matters which were for the CAT to determine (and which the CAT has in fact determined).
- 3.20 We are satisfied that the assessment that we must carry out in response to BT's appeal (specifically in relation to issues of proportionality) is whether the design of the Margin Condition addresses the risk Ofcom had identified (as upheld by the CAT), and does so in a manner that is no more restrictive than

⁶⁸ BT response to our provisional determination, paragraph 11(2).

⁶⁹ *British Telecommunications plc v Ofcom* [2015] CAT 13, paragraphs 41 & 42.

⁷⁰ *British Telecommunications plc v Ofcom* [2016] CAT 3, paragraph 187(b) and 205–224.

⁷¹ *British Telecommunications plc v Ofcom* [2016] CAT 3, paragraph 107.

⁷² *British Telecommunications plc v Ofcom* [2016] CAT 3, paragraph 185.

is necessary to meet that aim. We have done so by reference to the particular design errors alleged by BT. Given the CAT's findings, we are satisfied that it was not necessary to consider further (i) the nature and extent of the risk identified by Ofcom; or (ii) the market analysis undertaken by Ofcom.

- 3.21 In light of the CAT's findings that Ofcom's approach was not in error, we reject BT's suggestion that we have ignored BT's essential complaint that the reasoning and conclusions reached by Ofcom were flawed in light of the evidential basis and legal analysis undertaken by Ofcom.

Approach to the TalkTalk appeal

- 3.22 Three reference questions have been referred to us by the CAT in the TalkTalk Appeal, namely:⁷³

- (a) Reference question, 1 which relates to Ofcom's decision not to supplement the portfolio level test with a product-level test;
- (b) Reference question 2, which relates to Ofcom's decision not to use BT's call revenues for newly acquired customers when calculating the revenue of an adjusted EEO; and
- (c) Reference question 3, which relates to remedies.

- 3.23 We deal with each of reference questions 1 and 2 in turn.

4. BT Appeal: The design of the test

Introduction

- 4.1 As set out in paragraph 3.6, in this section we consider the reference questions which are relevant to BT's allegation that the Margin Condition is flawed in its design because it is overly restrictive: see reference questions 3(a), 3(b), 3(e) and 4(d). We also consider reference question 3(d) which relates to BT's allegation that Ofcom erred in adjusting the ACL used in the Margin Condition and a linked reference question on the adjusted EEO approach (reference question 4(b)). We describe below our reasoning for considering the reference questions in this order.

- 4.2 In its Core Submission Volume 2, BT groups together its discussion on reference questions 3(a) to (e) and, in addition to arguing that Ofcom erred in

⁷³ [Order of the CAT](#) (5 January 2016).

relation to each of these reference questions individually, BT also argues that each of the errors alleged in these questions compounds one another.

4.3 In light of this, we have looked at reference question 3 and have concluded that it would be prudent to assess questions 3(a), 3(b), 3(e) and 4(d) together for the following reasons:

- (a) BT contends that Ofcom has erred in designing a margin squeeze test that goes significantly beyond Ofcom's stated aim in imposing such a remedy, and in particular that it is 'unduly stringent', 'exceptionally rigid' and 'highly restrictive'.⁷⁴ These allegations relate to what we describe as 'the restrictive nature of the test' and are specifically relevant to reference questions 3(a), 3(b) and 3(e).
- (b) These questions appear to be closely linked in BT's pleadings.⁷⁵ We accept that these elements of the design of the test interact and that there is merit in considering the way they operate collectively as well as individually.
- (c) Any determination in BT's favour on one or more of reference questions 3(a), 3(b) or 3(e) might affect how the other questions we have grouped together in this section are to be determined. For example:
 - (i) BT's pleadings on LRIC+ focus, to some extent, on the implications of recovering common costs on a month-by-month basis. At its core submission hearing, when asked to clarify its concerns about the use of the LRIC+ standard, BT stated that, if the test is to be applied on a monthly basis, Ofcom should have used a LRIC costs standard (ie with no '+', the recovery of common costs) while recognising that 'that may leave a question of how [to] ensure that other costs are contributed to over time'.⁷⁶ The question of whether common costs should be recovered in the test is therefore, in our view, inextricably linked with the monthly test and how those costs are accounted for in the design of the Margin Condition.
 - (ii) Similarly, BT's arguments on what it describes as the 'bright line' test also focus on the monthly element:

No allowance is made within the Condition for consideration of either (i) the reasons why a *monthly* failure may occur or (ii) the likely effects such a failure

⁷⁴ BT AmNoA, paragraphs 161, 166, 168, 171 & 194.

⁷⁵ BT AmNoA, paragraphs 171 & 192.

⁷⁶ BT core submission hearing transcript, p32, lines 25–26.

would have on end-users. This serves to embed the key inflexible design features of the test outlined above, as Ofcom will not consider whether an observed *monthly* failure in a given *month* would actually affect the ability of efficient rivals to compete on the merits by profitably matching BT's SFBB.⁷⁷ [emphasis added]

- 4.4 Further, BT's argument under reference question 3(e) that the bright-line test applies without account being taken of exclusionary intention or effects, is similar to the argument it advances in reference question 4(d) on the need for evidence of exclusionary intention or effects. We therefore address reference question 4(d) in this section of the determination.
- 4.5 We first assess the individual and specific points relevant to reference questions 3(a), 3(b), 3(e) and 4(d). We then consider the relationship between these questions and the cumulative impact of Ofcom's approach. Finally in this section, we assess the issues raised by BT in reference question 3(d)/4(b) on the adjustment to the ACL.

Reference questions 3(a), 3(b), 3(e) and 4(d): Alleged restrictive nature of the test

- 4.6 The reference questions which relate to the restrictive nature of the Margin Condition are as follows:
- (a) Reference question 3(a), which requires the CMA to determine whether Ofcom erred in applying a LRIC+ test that is alleged to be unduly rigid in requiring BT's new retail SFBB subscribers to make a defined contribution to fixed and common costs ('the LRIC+ test').
 - (b) Reference question 3(b), which requires the CMA to determine whether Ofcom erred by applying the LRIC+ test on a month-by-month basis ('the monthly test').
 - (c) Reference question 3(e), which requires the CMA to determine whether Ofcom erred by applying the Margin Condition on a pass/fail basis in any given month with no tolerance for the extent to which BT is found to have failed or the reasons for or consequences of any such failure ('the bright-line test').
 - (d) Reference question 4(d), which requires the CMA to determine whether Ofcom erred in excluding any requirement for evidence either of

⁷⁷ BT core submission, volume 1, paragraph 41.

exclusionary intention or adverse effects on competition in the application of the Margin Condition.

Ofcom's approach

Reference question 3(a): LRIC+ test

- 4.7 LRIC refers to long-run incremental cost. It is the cost that can either be avoided by stopping, or incurred by increasing, production of a specified product or service, on the basis that all other products and services are still being provided at their original level. It captures all types of cost that can be avoided in the long run, including annual operating costs and an attribution of capital costs.
- 4.8 LRIC+ is a cost measure that, in addition to LRIC, includes a proportion of those elements of a firm's costs that are common between its different products and services, and are therefore not incremental to any of them in isolation. In practice, there is thus no single measure of LRIC+, as this is a relatively broad concept that can encompass different levels of contribution to common costs (ie the size of the 'plus'). However, in its Final Statement, Ofcom defined the specific form of LRIC+ that it intends to apply for the purposes of the Margin Condition based on a detailed cost allocation exercise.⁷⁸ We therefore focus throughout our assessment of this reference question on this specific definition of LRIC+ set out by Ofcom. Accordingly, references to LRIC+ in this document are to Ofcom's definition unless otherwise indicated.
- 4.9 In its Final Statement, Ofcom said that, for the Margin Condition, the question of the choice of the relevant cost standard was essentially a question about whether to require SFBB subscribers to make a contribution towards common costs.⁷⁹
- 4.10 Ofcom provided the following reasons for adopting a LRIC+ cost standard:
- (a) A LRIC+ cost standard produces dynamic efficiency benefits through promoting enhanced retail competition. By increasing the margin available to rivals, it encourages their entry and expansion, and may also allow them to achieve economies of scale and greater experience of offering fibre services.⁸⁰ Ofcom acknowledged that this may result in some short-

⁷⁸ BT refers to this as a fully-allocated cost standard (FAC).

⁷⁹ [Final Statement](#), paragraphs 5.34–5.56; in particular paragraph 5.42.

⁸⁰ [Final Statement](#), paragraphs 5.43–5.44.

term reductions in static efficiency, but argued that these would be outweighed by the dynamic efficiency benefits.

- (b) In the long term, it is likely that SFBB would need to make some contribution to common costs, and it is reasonable for the Margin Condition to reflect this long-run position. This is likely to support stable prices over time by avoiding a situation where common cost recovery shifts sharply from one product to another.⁸¹
- (c) A LRIC+ approach is consistent with Ofcom's general regulatory practice, as it typically takes common costs into account when setting charge controls and in other *ex ante* charge control cases.⁸²
- (d) The consequences of any errors in estimating costs are likely to be more serious under a LRIC cost standard and more likely to lead to a LRIC cost standard being ineffective in achieving Ofcom's regulatory aim. This is because under an alternative LRIC approach, costs could be underestimated. If the adjusted EEO's LRIC was underestimated and if BT set a VULA margin only just equal to the incorrectly estimated amount, then that margin would not be effective in achieving the regulatory aim and such an outcome could harm competition in the fibre segment. This would be because an adjusted EEO may be worse off if it won fibre customers since if it matched BT's prices, it would fail to cover its incremental costs.⁸³
- (e) Although Ofcom did not explicitly cite this as a reason for its choice of a LRIC+ standard, later in the Final Statement it noted that its approach was consistent with the Commission's Recommendation on consistent non-discrimination obligations and costing methodologies to promote competition and enhance the broadband investment environment ('the 2013 Recommendation'). This recommends that a LRIC+ model consisting of incremental costs and a mark-up for common costs should be used.⁸⁴

⁸¹ [Final Statement](#), paragraph 5.45. In footnote 263, Ofcom further explains that there is likely to come a point where there are so few copper broadband subscribers that it is necessary for fibre broadband subscribers to make a contribution in order to ensure that common costs are recovered.

⁸² [Final Statement](#), paragraphs 5.47–5.50. Ofcom accepts that in some cases it has not taken common costs into account, but it considers these to be exceptions that reflect the specific features of the products in question.

⁸³ [Final Statement](#), paragraphs 5.51 & 5.52 and footnote 274. Ofcom also recognises that there is a risk that the margin could be over-estimated, but argues that the risks here are asymmetric (ie overestimating the necessary margin is not as bad as underestimating it).

⁸⁴ [Final Statement](#), paragraph 7.108.

Reference question 3(b): Monthly test

- 4.11 In the Consultation, Ofcom explained that the test would be run in order to assess whether, during any assessment period, a minimum margin is maintained by BT.⁸⁵ The phrase ‘assessment period’ was described as ‘any period over which OFCOM makes an assessment under this condition’.⁸⁶ However, elsewhere in the Consultation, Ofcom stated that its proposal was for ‘BT to provide the data necessary to monitor compliance with the proposed VULA margin condition to Ofcom every six months, with Ofcom conducting a high level assessment of the margin at six monthly intervals’.⁸⁷
- 4.12 In the Final Statement, Ofcom clarified that there is a distinction between the ‘compliance period’, which is the period over which it will evaluate whether BT has satisfied the Margin Condition and the assessment period, which refers to how often BT will be required to submit data to Ofcom and which spans multiple compliance periods.⁸⁸
- 4.13 Consistent with the Consultation, Ofcom stated in its Final Statement that it would use an assessment period of six months. However, after clarifying the distinction between the concepts of the assessment and compliance periods, it said that it would use a compliance period of one month.⁸⁹ As set out below, it is the length of the compliance period that BT disputes in this appeal.

Reference question 3(e): Bright-line test

- 4.14 When consulting on the Margin Condition, Ofcom’s provisional conclusion was that it was not appropriate for the VULA margin assessment to incorporate a further assessment of the effects of BT’s price on competition and/or consideration of whether BT’s prices are objectively justified.⁹⁰
- 4.15 In the Final Statement, Ofcom confirmed that the test would not include an effects-based analysis, and instead decided that any instances of BT’s margin being insufficient would constitute a breach of the Margin Condition. Ofcom’s

⁸⁵ [Ofcom Consultation](#), paragraph 14.2.

⁸⁶ [Ofcom Consultation](#), paragraph 14.4; Ofcom hearing transcript (BT Appeal), pp25–27. At the main party hearing, Ofcom clarified that it originally intended to operate the Condition using ‘continuous compliance’, in other words to examine BT’s compliance under any period that Ofcom felt was relevant to assess, particularly in the light of any complaint received. Ofcom stated that it saw benefits of this approach in giving it flexibility to focus its assessments on specific or very short periods if it felt it appropriate to examine these, though it accepted that in hindsight this approach may not have been entirely clear.

⁸⁷ [Ofcom Consultation](#), paragraphs 4.78 & 4.106.

⁸⁸ [Final Statement](#), paragraph 6.11A.

⁸⁹ [Final Statement](#), paragraph 6.11A. Ofcom notes at paragraph 6.35B that in applying a monthly compliance period it will use data from that specific compliance period for some cost and revenue items, though does not appear to present that as a reason for selecting a one month compliance period over other possible alternatives.

⁹⁰ [Final Statement](#), paragraph 4.30.

Final Statement outlines two main reasons for its adoption of this bright-line approach:

- (a) There is no requirement to carry out an effects analysis as part of any remedy imposed under *ex ante* regulation.⁹¹
- (b) A remedy that included an effects analysis would not meet Ofcom's regulatory aim.⁹² Ofcom provided a number of further reasons for the adoption of what it refers to as a 'clear pricing rule' in the context of its regulatory aim:⁹³
 - (i) This will provide BT with clarity and certainty for it to comply with the Margin Condition.
 - (ii) In turn, this will provide BT's competitors with certainty over the level of the VULA margin, allowing them to make decisions about investing in winning SFBB subscribers.
 - (iii) This will aid swift and effective enforcement, as the inclusion of an effects analysis could significantly undermine the effectiveness of the pricing rule.
 - (iv) As a matter of principle, this is Ofcom's starting point for *ex ante* pricing rules and is the approach it has adopted in a number of other cases.
 - (v) To the extent that a bright-line test is a simplification (in that it is possible that a price that just fails a bright-line test may not harm competition and, similarly, a price that just passes may, in fact, damage competition), this is an inherent feature of *ex ante* regulation, and the risks of this can be minimised through the way in which Ofcom assesses costs, revenues and volumes.

⁹¹ [Final Statement](#), paragraphs 4.37–4.40. This was confirmed by the CAT in *British Telecommunication plc v Ofcom* [2016] CAT 3.

⁹² [Final Statement](#), paragraphs 3.93 & 4.41. Ofcom's regulatory aim is to ensure that BT does not set the VULA margin such that it prevents an operator that has slightly higher costs than BT (or some other slight commercial drawback relative to BT) from being able to profitably match BT's retail SFBB offers.

⁹³ [Final Statement](#), paragraphs 4.41–4.47.

BT's case

4.16 Reference questions 3(a), 3(b) and 3(e) form part of Ground 4 of BT's Amended Notice of Appeal. In its introduction to Ground 4, it argues that:

the **methods** applied, **calculations** used and/or **data** used in determining the Condition are inappropriate and unnecessary to address the risk that BT might engage in an exclusionary margin squeeze in relation to the supply of SFBB inputs to the UK retail broadband market.⁹⁴ [original emphasis]

4.17 BT further contends that 'Ofcom erred in designing a margin squeeze test which goes significantly beyond Ofcom's own stated aim in imposing such a remedy, i.e. to ensure that BT's competitors could profitably match BT's SFBB offers'.⁹⁵

Reference question 3(a): LRIC+ test

4.18 In reference question 3(a), BT criticises Ofcom's overall approach to the recovery of its common costs. We sought clarification during the hearings as to precisely which specific elements of Ofcom's approach to common costs BT was challenging and any proposed alternative.⁹⁶ We have also addressed specific points raised in BT's various submissions during the course of the appeal where we consider they develop BT's case from that set out in its Amended Notice of Appeal. We cite these as they arise in the assessment that follows.

4.19 In its Core Submission Volume 2, BT clarifies that it is Ofcom's choice of a LRIC+ cost standard using a cohort approach that is the specific focus of this reference question.⁹⁷ Moreover, when asked at its main party hearing whether it was arguing in favour of LRIC or LRIC+ with a smaller 'plus', BT replied that its concerns relate to the alleged rigidity of requiring a defined monthly contribution to common costs which is assessed on a bright-line basis. In the hearing, BT argued that if the test is based on monthly cohorts and is applied on a bright-line basis, then it should be focused on the costs that are driven by

⁹⁴ BT AmNoA, paragraph 160. BT's original NoA had proposed that Grounds 1 to 3 should form part of the CAT's judgment.

⁹⁵ BT AmNoA, paragraph 161; BT core submission, volume 2, paragraph 97. In its core submission, BT makes clear that there are several related aspects of Ofcom's approach that it does not contest, in particular its use of a cohort approach, a portfolio approach, and a properly designed lifetime profitability test.

⁹⁶ See paragraph 4.19

⁹⁷ BT core submission, volume 2, paragraph 96.

that cohort.⁹⁸ BT stated that, if the analysis were being undertaken on a monthly basis, then an approach based on LRIC would be appropriate.⁹⁹

- 4.20 We therefore interpret BT's comments at its hearing on this reference question as being that, if the test were operated on a bright-line basis with a monthly compliance period, the Margin Condition should be operated on a LRIC basis instead of the specific LRIC+ cost standard defined by Ofcom.
- 4.21 We do not consider that the pleadings in support of this reference question in BT's Amended Notice of Appeal provided a specific challenge to what Ofcom included in its LRIC+ calculation, ie the size of the 'plus'; nor did it put forward a specific alternative approach. Rather, the Amended Notice of Appeal made a general statement that 'profitable pricing need not require that each monthly cohort of new customers makes a specific contribution to costs which could be recovered from other services, from the existing SFBB customer base, and/or from different cohorts of new customers in different months'.¹⁰⁰
- 4.22 However, in its response to our provisional determination, BT argued that we had failed to consider the extent to which its common costs could be recovered from different cohorts of SFBB customers over time, or how they might be recovered from different groups of customers and services. Notwithstanding our assessment in paragraph 4.21, for completeness we nevertheless consider this argument further below. Also, to the extent that BT raised specific objections to Ofcom's approach to the calculation of the margin requirement and put forward a specific alternative approach under other reference questions we deal with these points in our discussion of these questions. An example is the treatment of the costs of BT Sport, which we consider in Section 6.
- 4.23 On the issue of the use of a LRIC+ standard versus a LRIC standard, BT argues that the use of an 'exceptionally rigid' LRIC+ test is wrong both as a matter of principle and in the wider context of the test that Ofcom has imposed.¹⁰¹ In its Amended Notice of Appeal, BT raises two specific criticisms of this approach:
- (a) A LRIC+ cost standard is not necessary to ensure that an (adjusted) EEO can profitably match BT's retail SFBB offers. BT's competitors would regard customers as profitable if they covered the incremental costs of supply and made at least some incremental contribution to common

⁹⁸ BT hearing transcript, pp6–7.

⁹⁹ Core submission hearing transcript (BT Appeal), p32, line 11 to p33, line 13.

¹⁰⁰ BT AmNoA, paragraph 167.

¹⁰¹ BT AmNoA, paragraph 166.

costs. Profitable pricing need not require that a group of new customers make a specific contribution to costs which could be recovered from other services, existing SFBB customers and/or different cohorts of new customers in different months.¹⁰²

- (b) A LRIC+ cost standard will result in a 'price umbrella'; in other words, it will force BT to set higher retail prices to consumers, which will in turn allow BT's rivals to profitably undercut it.¹⁰³

Reference question 3(b): Monthly test

4.24 BT criticises the fact that Ofcom will assess its compliance with the Margin Condition on a month-by-month basis, and argues that this compounds the impact of the 'rigid' LRIC+ approach.¹⁰⁴ It presents four arguments for why Ofcom was wrong to use a monthly compliance period:¹⁰⁵

- (a) BT's competitors would not face such rigid constraints in how they recover their common costs.¹⁰⁶
- (b) BT could fail the margin test simply because of a fall in the number of new customers in a month, as it may then not cover its upfront customer acquisition costs.¹⁰⁷
- (c) This is directly inconsistent with the Commission's Comments which, BT asserts, found that even a six-monthly assessment period was unduly short. BT also makes this point under reference question 1, where it asserts that Ofcom failed to take 'utmost account' of the views of the Commission.¹⁰⁸
- (d) Ofcom has apparently ignored its own reasoning for proposing six-monthly assessments initially.¹⁰⁹

¹⁰² BT AmNoA, paragraph 167; First witness statement of James Tickel (BT Appeal), paragraphs 102(a) and 104–107; RBB report, paragraphs 115–128.

¹⁰³ BT AmNoA, paragraph 169; RBB report, paragraph 126.

¹⁰⁴ BT AmNoA, paragraphs 161(b) and 170–172; First witness statement of James Tickel (BT Appeal), paragraphs 102(b) and 108–112; RBB report, paragraphs 127–128.

¹⁰⁵ Note that in its discussion of reference question 3(b), BT's Amended Notice of Appeal makes reference to the 'assessment period'. However, as Ofcom notes in footnote 31 of its Defence, these would appear in fact to be references to the compliance period, and we treat these as such.

¹⁰⁶ BT AmNoA, paragraph 171.

¹⁰⁷ RBB report, paragraph 128.

¹⁰⁸ BT AmNoA, paragraph 172.

¹⁰⁹ BT AmNoA, paragraph 172.

Reference question 3(e): Bright-line test

4.25 BT also criticises Ofcom's rejection, in its Final Statement, of a remedy that included an effects analysis on the basis that such a remedy would allegedly not meet Ofcom's aim. In effect, under reference question 3(e), BT challenges the implementation of a bright-line test.¹¹⁰ BT's main criticisms are the following:

- (a) The bright-line test assesses whether BT passes or fails 'on the numbers', and does not take into account:¹¹¹
 - (i) the quantum (or extent) of any failure to meet the required margin. The effect of this is that, even if the margin earned on the cohort in a single month turns out to be, for example, one penny below the level of margin required, then BT would be in breach of the Margin Condition;
 - (ii) the circumstances (or reasons) surrounding any failure to meet the required margin, including market and commercial factors and any exclusionary intention on the part of BT. In particular, BT states that there can be significant monthly variation in the net costs of BT Sport for seasonal reasons;¹¹² and
 - (iii) the effect of any failure to meet the required margin, in particular any impact on competition and consumers.
- (b) Ofcom's reasoning for adopting a bright-line test, ie that 'simplification is an inherent feature of *ex ante* regulation', is not adequate, particularly in a sector characterised by complexity and highly differentiated retail offerings.¹¹³
- (c) Ofcom failed to take 'utmost account' of the 2013 Recommendation, which BT claims makes specific provision for the application of an effects-based approach.

¹¹⁰ BT AmNoA, paragraphs 161(e) and 190–195; First witness statement of James Tickel (BT Appeal), paragraphs 112 & 120; RBB report, paragraphs 146–184.

¹¹¹ BT AmNoA, paragraphs 192–194; First witness statement of James Tickel (BT Appeal), paragraph 120. The issue of the seasonality of the net costs of BT Sport is raised specifically by BT in Reference Question 3(f).

¹¹² First witness statement of James Tickel

¹¹³ BT AmNoA, paragraph 192–194.

Reference question 4(d): Evidence of exclusionary intention or adverse effects

- 4.26 Under reference question 4(d), BT raises similar concerns to that of reference question 3(e), stating that Ofcom erred in excluding or ignoring the need for evidence either of exclusionary intention or adverse effects on competition, in the event that margins are above variable retail costs but below total cost.¹¹⁴
- 4.27 BT goes on to state that this amounts to an error of principle, in that Ofcom specifically considered and rejected BT's suggestion, at the consultation stage, that the proposed *ex ante* regulation should include an assessment of the effect on competition.¹¹⁵
- 4.28 BT also relies on the European case law on margin squeeze¹¹⁶ and asserts that Ofcom erred in law in drawing a distinction between the requirements of competition law and regulation designed to promote effective and sustainable competition. At the very least, BT argues that the emphasis on an effects-based approach to the enforcement of the prohibition on exclusionary abuse should have served to demonstrate the inadequacy of Ofcom's superficial analysis of whether there was a relevant risk of adverse effects.¹¹⁷

Our assessment of reference questions 3(a), 3(b), 3(c) and 4(d): The alleged restrictive nature of the test

Introduction

- 4.29 We consider first BT's arguments that are specific to each of the three elements of the design of the test (LRIC+, monthly test and bright-line). We then assess BT's arguments on the combined impact of these elements and the effect on the test in the way they interact.

Reference question 3(a): LRIC+

- 4.30 We assess BT's case under reference question 3(a) in line with the position set out in paragraph 4.20 above and taking into account BT's response to our provisional determination.
- 4.31 In considering BT's arguments in relation to Ofcom's decision to adopt a LRIC+ standard instead of LRIC standard, we accept that, at least in the short

¹¹⁴ BT AmNoA, paragraph 241(d).

¹¹⁵ BT AmNoA paragraphs 253–256.

¹¹⁶ BT AmNoA, paragraphs 24–36 & 235.

¹¹⁷ BT AmNoA, paragraphs 254 & 255.

run, BT's rivals do not need, as BT asserts, to be able to cover their common costs in order to profitably match BT's retail offers. Typically, firms only need to cover LRIC for a product to be individually profitable, in that by doing so they are making some contribution to their common costs and the firm is better off producing that product than not doing so.¹¹⁸

- 4.32 However, there are different concepts of profitability. In particular, as well as ensuring that each individual product is incrementally profitable, firms also have to cover their common costs to ensure that their operations are profitable as a whole. Ofcom's approach to common costs recovery in the Margin Condition is consistent with this broader concept of profitability and is not an uncommon approach to adopt in *ex ante* regulation.¹¹⁹ For example, Ofcom noted in its Final Statement that it applied a LRIC+ approach when regulating, on an *ex ante* basis, BT's margin between ATM interconnection and IP stream.¹²⁰ It also commented that it typically takes common costs into account when setting charge controls, and highlighted that it used this approach in the WLR/LLU, the WBA and the leased lines charge controls. Therefore, in our view BT's arguments about the need for rivals to cover costs on a LRIC-only basis are not capable in themselves of demonstrating that Ofcom has erred.
- 4.33 Applying this broader concept of profitability means that BT faces a larger margin requirement than if Ofcom had applied a LRIC approach. BT argues that a LRIC+ cost standard will result in a 'price umbrella' which is 'likely to render retail competition less and not more effective'.¹²¹ In its response to our provisional determination BT clarified that by 'price umbrella' it means that, because it has to satisfy this larger margin requirement, there is a risk that its rivals would be able to undercut its retail price, leaving it at a competitive disadvantage.
- 4.34 However, we consider that Ofcom took into account the potential risks of this larger margin requirement and the potential consequences of its approach. In response to BT's arguments, Ofcom refers back to its primary justification for the adoption of a LRIC+ standard. This is that, although the LRIC+ approach will result in monthly cohorts of customers covering costs that are not directly driven by (ie incremental to) them, this will produce long-run efficiency

¹¹⁸ It is for this reason that a LRIC cost standard is often used in the *ex post* assessment of exclusionary abuses. For example, the RBB report argues that this is reflected in the European Commission's Article 102 guidance paper.

¹¹⁹ This is also consistent with footnote 2 of the European Commission's Article 102 guidance paper, which states that 'in situations where common costs are significant, they may have to be taken into account when assessing the ability to foreclose equally efficient competitors'.

¹²⁰ [Final Statement](#), paragraphs 5.47–5.49.

¹²¹ RBB report, paragraph 126.

benefits through ‘encouraging entry and allowing rival retailers to grow’ and that this will offset any short-term inefficiencies.¹²² At BT’s main party hearing, Ofcom emphasised that it is specifically aiming to go beyond *ex post* competition law, where a LRIC standard is typically adopted, and that the LRIC+ standard is consistent with its overall duties to promote competition.¹²³

- 4.35 In the context of the regulation of the SFBB segment, where Ofcom’s aim is to promote competition actively, we believe that Ofcom is correct that this pricing must be such as to ensure competitors’ ‘fibre broadband subscribers ... make a contribution to common costs’.¹²⁴ On this point, we accept the arguments made during the Consultation by Ofcom, TalkTalk and [redacted] that, if rivals are constrained to earn only LRIC at the SFBB portfolio level, they may have little incentive to invest in the provision of SFBB.¹²⁵
- 4.36 Further, we also consider it relevant that BT has some flexibility over how it meets the Margin Condition. We accept that this does not remove the risks associated with a greater margin requirement and that there may be some regulatory constraints on the extent to which BT can reduce the VULA wholesale price.¹²⁶ Nevertheless, a Margin Condition offers greater flexibility for BT compared with, for example, a wholesale or retail price cap. This greater flexibility means the likely effect on retail prices of different approaches to common costs within the Margin Condition is not clear.
- 4.37 BT argues that there is no clear evidence that dynamic benefits outweigh the short-term costs of Ofcom’s approach, and in paragraph 113 of its response to our provisional determination further emphasised Ofcom’s lack of empirical analysis.¹²⁷ While BT is correct that Ofcom has not provided evidence on the relative size of the long-term benefits and short-run costs of this approach, the Final Statement did include a qualitative assessment of the risks of a margin squeeze. This emphasised that the current market review period is an important one of transition to SFBB that will shape the effectiveness of competition in future, especially as the constraint from SBB diminishes.¹²⁸
- 4.38 It is far from clear what would constitute clear evidence of the relative size of dynamic benefits and short-term costs, or that a quantitative analysis by Ofcom was necessary for it to reach its conclusions. Any quantitative analysis

¹²² [Final Statement](#), paragraph 5.44 and Ofcom defence, paragraph 270

¹²³ Ofcom hearing transcript (BT Appeal), pp8–9; [Final Statement](#), paragraphs 3.64–3.67, where it discusses the size of BT’s and its rivals’ subscriber bases, and the role that these play in determining the competitive constraints that BT faces.

¹²⁴ [Final Statement](#), paragraph 5.45. Witness statement of David Matthew, paragraphs 22 & 35, which states that [redacted].

¹²⁵ TalkTalk statement of intervention, footnote 4; [Final Statement](#), paragraph 5.36 and footnote 262.

¹²⁶ BT response to our provisional determination, paragraphs 31–33.

¹²⁷ BT core submission, volume 2, paragraph 103.

¹²⁸ [Final Statement](#), Section 3, paragraphs 3.83–3.92.

would involve likely speculative assumptions about the size of the costs and benefits of including a contribution to common costs in the Margin Condition. BT has not undertaken quantitative analysis itself, nor submitted any clear evidence that the long-term benefits of this approach are outweighed by the potential short-term costs. Balancing short-term and long-term considerations of this sort is a difficult matter of judgement which falls within the regulator's discretion. BT has not demonstrated any errors in Ofcom's approach, and in our view Ofcom was justified in taking this approach.

- 4.39 For completeness, as set out in paragraphs 4.21 to 4.22 above, we also comment on BT's criticism in its response to our provisional determination that Ofcom's approach to the calculation of the size of the 'plus', and our assessment of BT's reference question on LRIC+, should have considered how these costs could be recovered from different groups of customers and services to which those common costs are also relevant.¹²⁹
- 4.40 In our view, Ofcom considered alternative approaches to how costs could be recovered from other groups of products or consumers and gave good reasons for the approach it adopted. On the relevant group of products, Ofcom decided to focus on SFBB only, and not include SBB, because its competition concerns relate to SFBB, rather than broadband as a whole.¹³⁰ We also consider it relevant that if SBB revenues were to be included in the test, then this could allow BT to charge very low prices for SFBB products, offset by higher margins on SBB products.
- 4.41 Ofcom also considered whether the test should focus on new SFBB subscribers, or also existing subscribers.¹³¹ It found that only a focus on new SFBB customers would be consistent with its regulatory aim, as essentially it is for new customers where competition takes place. Moreover, including existing SFBB customers would potentially risk BT charging very low prices to new customers offset with higher margins on existing SFBB customers, thereby making it difficult for other operators to compete.
- 4.42 In conclusion, we note that Ofcom's competition concerns relate to the ability of BT's rivals to compete effectively for new SFBB customers.¹³² We find the fact that the Margin Condition requires BT to make a specific contribution to its common costs from this particular group of products and customers, in isolation from the rest of its operations, is consistent with Ofcom's regulatory aim for the reasons it has given.

¹²⁹ BT response to our provisional determination, paragraph 23.

¹³⁰ [Final Statement](#), paragraphs 5.111-5.140.

¹³¹ [Final Statement](#), paragraphs 6.61-6.68.

¹³² [Final Statement](#), paragraphs 5.113 and 6.66.

Reference question 3(b): Monthly test

- 4.43 The key criticism made by BT is that the monthly test substantially limits its flexibility over how it is able to recover its common costs over time and that this will hamper its ability to compete effectively against its rivals. The fact that Ofcom has adopted a LRIC+ cost standard means that [redacted] of the margin requirement is related to costs not directly driven by individual monthly cohorts: [redacted].¹³³
- 4.44 Ofcom acknowledged that in selecting the appropriate compliance period, a trade-off must be made between selecting a shorter period (which may better address any risks to competition) and a longer period (which would grant BT additional flexibility). Ofcom also accepted that applying a LRIC+ test on a short compliance period is a tougher test than if it had adopted a longer compliance period.¹³⁴
- 4.45 We understand Ofcom to have balanced two factors in setting the length of the compliance period:
- (a) the need to address any risks to competition arising out of the extent to which BT would be able to:
 - (i) set a lower margin for some of the compliance period, offsetting it by a higher margin for the rest of the period; and
 - (ii) structure its pricing across two compliance periods [redacted] to maintain a low margin for a relatively long period;¹³⁵ and
 - (b) the need to ensure that BT's flexibility in pricing was not restricted any more than is needed to address those risks, and the fact that in practice a degree of fluctuation in the margin may not significantly harm the ability of rivals to compete.¹³⁶
- 4.46 We agree that Ofcom was correct to seek to balance these two factors, particularly that BT's flexibility in pricing should not be constrained more than necessary to address the risks to competition. We have therefore assessed the arguments Ofcom made in the course of this appeal which suggested to it

¹³³ [redacted].

¹³⁴ BT hearing transcript, pp11–12: (i) 'We recognise there's a trade-off here between the risks of setting a short compliance period in terms of gaming and so forth, and on the other hand a longer compliance period, it does give BT more flexibility'; and (ii) 'yes, you can see that a short compliance period combined with a LRIC+ is a tougher test on BT than one which was a long compliance period with LRIC+ or one which is of a lower standard. So I absolutely accept that.' More generally, Ofcom recognised this in the context of its decision to apply a SFBB portfolio test, rather than a product-level test: [Final Statement](#), paragraph 5.127.

¹³⁵ Ofcom defence (BT Appeal), paragraph 287.

¹³⁶ Ofcom defence (BT Appeal), paragraph 288.

that a one-month compliance period was necessary and, in particular, whether these justified the additional restriction on BT's flexibility compared to the use of a longer compliance period.

- 4.47 In doing so, we note that Ofcom did not consult on the use of a one-month compliance period, nor did it provide any detailed reasoning in its Final Statement for this decision. In seeking to understand Ofcom's reasoning for adopting a one-month compliance period, we are therefore reliant on the points it makes in its Defence.
- 4.48 We accept that the factors set out in paragraph 4.45 provide a sound basis for not imposing a substantially longer compliance period, for example, of the order of several years. In such circumstances, a CP could be dissuaded from investing in its SFBB provision if it could face a low VULA margin for an extended period of time, even if it were aware that there would be a period of high margin thereafter.
- 4.49 However, concerns about an intra period margin squeeze do not provide a good reason for selecting a compliance period as short as one month. In our view, Ofcom has placed too much weight on the harm that competitors could face in their ability to compete as a result of them earning a low margin for a short period, in particular of only one month. We base our finding here on the following three reasons:
- (a) SFBB is an industry where firms take a long-term perspective on competition and profitability, and are willing to trade off present costs for future profits. This is illustrated by the fact that the duration of customers' contracts are typically at least one year, and the ACL is approximately five years.¹³⁷
 - (b) If the compliance period were longer, BT's rivals would know that for it to satisfy the margin requirement over the entire compliance period, any period of low prices by BT would have to be accompanied by a period of high prices. Moreover, the total additional margin earned across all sales by BT during these high price periods would have to offset fully its total shortfall in margin when its prices were low, so its rivals would likely have every incentive to continue competing aggressively in anticipation of potentially making a substantial number of sales in future. In relation to Ofcom's argument that some short periods may be particularly important for competition we note that, even if this is the case (which Ofcom has not

¹³⁷ BT core submission, Volume 2, paragraph 114. For example, BT argues that CPs take a long-term perspective on profitability where it states that 'in reality, efficient rivals could compete on the merits if lifetime revenues of the acquired customers were expected to exceed the lifetime costs driven by that cohort'. [38].

demonstrated), if BT were to make many sales at low margins during these times this would be captured by the test and result in it having to engage in an even greater offsetting increase in margin in other periods. We therefore do not find this justification for a one-month compliance period to be persuasive.

(c) Because of Ofcom's adoption of a LRIC+ standard, [X] of the margin requirement relates to the recovery of common costs. It seems particularly unlikely that rivals would be harmed because they were unable to make a full contribution to these in each and every short time period.¹³⁸ Thus, in our view, it is in the context of the monthly test that BT's arguments about LRIC+ carry most weight.

- 4.50 We therefore agree with BT that there is no basis for supposing, whether viewed as a matter of commercial reality or economic theory, that any competitor would be harmed in its ability to compete over the short- or long-term if such a test were failed in a single month. We also agree with BT that, even if the efficient rival could not profitably compete in a single month, that would not make it an ineffective competitor in the following month or over the long term.
- 4.51 We do not agree with Ofcom's argument that, for example, a six-month compliance period necessarily creates a risk of an intra-period squeeze. The factors we highlight in paragraph 4.49 are also, in our view, relevant to an assessment of the risks associated with a six-month compliance period. Ofcom has not demonstrated that any risks with a six monthly compliance period necessarily need to be mitigated by a significantly shorter period.
- 4.52 We therefore consider that in balancing (i) the risks to competition that Ofcom identified in setting a longer compliance period, against (ii) the requirement to provide BT's with additional flexibility, Ofcom placed too much weight on the risks to competition which, for the reasons given above, we do not consider to be made out.
- 4.53 We also find no merit in Ofcom's argument that a monthly compliance period means that for bundle subscription prices and Openreach input charges, the prices and charges applicable during a particular month can be used.¹³⁹ The fact that prices and charges apply on a monthly basis may inform the data

¹³⁸ First witness statement of James Tickel (BT Appeal), paragraph 112. BT argues that, in the context of how its competitors will make commercial decisions, profitable pricing need not require each cohort of new customers to make a specific contribution to common costs in each month, as these can be recovered from (among other things) different cohorts of customers acquired in different months.

¹³⁹ Ofcom defence (BT Appeal), paragraph 289.

sources used, as set out in Ofcom's Final Statement; it does not, in our view, justify that the test must be met on a monthly basis.

- 4.54 Ofcom also explained to us that the Margin Condition more generally provides BT with additional flexibility in relation to its pricing.¹⁴⁰ While we accept this, we do not consider that this additional flexibility, in itself, justifies a substantially less flexible approach with respect to the length of the compliance period.
- 4.55 Finally, BT has argued that the monthly test is 'directly inconsistent' with the Commission's Comments, and says that this is contrary to the obligations of Ofcom to take 'utmost account' of the Commission's view under Articles 7 and 19 of the Framework Directive.¹⁴¹ We consider that none of the Commission's comments was relevant to the length of the compliance period. We agree with Ofcom's assessment that 'the Commission was not advocating a different compliance period while otherwise maintaining Ofcom's approach. Rather the Commission was suggesting the adoption of a different approach altogether'.¹⁴²

Reference question 3(e): Bright-line test

- 4.56 On BT's arguments relating to the bright-line application of the Margin Condition, we acknowledge that a consequence of operating the test on a pass/fail basis is that this will not include any consideration of the quantum, circumstances or effect of any failure by BT.
- 4.57 BT argues that the test should include an effects-based analysis. BT says this is in accordance with the case law of the European Courts on Article 102 of the Treaty on the Functioning of the European Union (TFEU) as regards a margin squeeze, and is required by the duty to take utmost account of the 2013 Recommendation that enforcement action should be taken under the CRF, in particular, under Article 10 of the Authorisation Directive. However, the bright-line test forms part of the design of the *ex ante* regulatory test, not of any enforcement action which may be taken. The 2013 Recommendation states that '*ex ante* economic replicability test [...] is different from and without prejudice to margin squeeze tests that may be conducted *ex post* pursuant to competition law'.¹⁴³ We note that the CAT's judgment on the non-specified

¹⁴⁰ Ofcom hearing transcript (BT Appeal), pp16–17. At BT's main party hearing, Ofcom referred to the flexibility that it gives BT over its pricing across the SFBB portfolio, and also noted the additional flexibility it offered in the case of UEFA rights.

¹⁴¹ BT AmNoA, paragraph 172.

¹⁴² Ofcom defence (BT Appeal), paragraph 209.

¹⁴³ [The 2013 Recommendation](#), point 26.b.

price control matters in this appeal includes the view that ‘an Article 102 assessment differs from the present [*ex ante*] assessment in that it addresses the legality of a particular course of conduct’.¹⁴⁴ We therefore consider that neither Article 10 of the Authorisation Directive nor the case law on Article 102 TFEU is helpful to deciding whether Ofcom has erred by applying the Price Control on a pass/fail basis in any given month.

- 4.58 BT also argues that there are some elements of the test that it potentially cannot control precisely, such as BT Sport costs and new customer numbers. This means that, if there were to be an unexpected large variation in costs or customer numbers, this could result in BT breaching the Margin Condition by accident and thereby potentially incurring a financial penalty.
- 4.59 We consider the seasonality of BT Sport costs at paragraphs 6.32 to 6.43 below. However, here we note that BT has not conclusively demonstrated that (i) customer numbers or sports costs do in practice vary substantially on a monthly basis, and (ii) any such variations are, in any event, unpredictable such as to lead BT to breaching the Margin Condition accidentally. For example, BT argues that BT Sport costs vary substantially over time, in particular because of seasonality and long-term trends. It points to the fact that [REDACTED].¹⁴⁵[REDACTED], their impact on BT’s compliance with the Margin Condition should be predictable.¹⁴⁶
- 4.60 Further, on new customer numbers, BT has not pointed to figures that demonstrate that these vary substantially on a monthly basis. Having said this, we recognise that BT clearly does face a degree of uncertainty in the number of new customers it gains, particularly in light of the fact that its compliance with the Margin Condition is evaluated on a monthly basis. Moreover, this uncertainty is likely to be greatest in respect of the number of new customers it may attract, and the rate at which it may attract them, as a result of additional investments to enhance its retail offering.
- 4.61 Overall, on the basis of the evidence that has been presented to us, we find that there is little uncertainty on costs such that it creates risks of an inadvertent breach of the Margin Condition. Nevertheless, while we observe little month-on-month variation in customer numbers, we agree with BT that it inevitably faces some demand-side uncertainty. This suggests that Ofcom’s adoption of a monthly compliance period means that there is at least some risk that BT could fail to comply as a result of factors beyond its control. We

¹⁴⁴ *British Telecommunications plc v Ofcom* [2016] CAT 3, at paragraph 128.

¹⁴⁵ First witness statement of James Tickel (BT Appeal), paragraph 133.

¹⁴⁶ For example, [REDACTED].

consider that this risk would be addressed by the adoption of a longer compliance period.

- 4.62 On the issue of the quantum and effect of any failure, we accept BT's point that it could be found to be in breach of the Margin Condition as a result of a very small shortfall in the required margin in only a single month.¹⁴⁷ We also consider it relevant to our consideration of the way the test operates, that any breach by BT of the Margin Condition, even if only by a small amount, could have negative implications for it – not only in possible enforcement by Ofcom, but also in increased regulatory scrutiny, adverse public relations and possible legal challenge.¹⁴⁸
- 4.63 Ofcom indicated that it would not meet its regulatory aim if the Margin Condition required there to be an additional or alternative assessment of economic harm at the point of a breach, or for there to be an assessment of the circumstances of any breach. Ofcom expressed concern that any such further assessment would put at risk swift and effective enforcement. It also said that a bright-line test provides certainty to BT and its competitors compared with the alternatives.
- 4.64 BT argues that Ofcom's justification is highly theoretical and demonstrates a lack of proportionality. However, Ofcom's reasoning focuses on the practical enforceability of the Margin Condition. We accept that to place weight on practical enforceability was justified and proportionate. Furthermore, we agree that a bright-line test offers legal certainty to all market participants, in contrast to an approach which requires a further assessment of circumstances and competitive effects.
- 4.65 We have therefore come to the view that the interests of enforceability and legal certainty justify the adoption of a bright-line test and that the risk identified by BT that it could be found to be in breach as a result of a very small shortfall in the required margin in only a single month is likely to be satisfactorily managed by the adoption of a longer compliance period.

¹⁴⁷ [Final Statement](#), paragraph 4.46. This is again inevitably a consequence of the use of a bright-line test, and is one that Ofcom was aware of and considered.

¹⁴⁸ BT hearing transcript (BT Appeal), pp27–29. BT stated that any breach of the condition could trigger a range of consequences, not just those relating to financial penalties. These could also include damages actions and increased regulatory scrutiny of its compliance processes. [Final Statement](#), paragraphs 4.112 & 4.113. Ofcom indicated that in determining the amount of any penalties it will have regard to its Penalty Guidelines, which do emphasise a consideration of the circumstances surrounding any breach.

Reference question 4(d): Evidence of exclusionary intention or adverse effects

- 4.66 As we set out in paragraph 4.4, this reference question raises similar issues as those raised in reference question 3(e); that is, that Ofcom erred in not taking account of exclusionary intention or effects, either in its design of a bright-line test or as a matter of principle. Both questions relate to whether there should be any regard given to the effect of any ‘failure’ of the test and what such a failure reveals about competition. Therefore, we refer back to our assessment of reference question 3(e) as set out above and, in particular, paragraphs 4.63 and 4.64.
- 4.67 BT raises one additional argument under this reference question, namely that Ofcom erred in law in seeking to distinguish between the requirements of competition law and *ex ante* regulation designed to promote effective and sustainable competition.
- 4.68 It is clear from the CAT’s judgment on the non-specified price control matters that the case law on Article 102 is not binding on Ofcom in relation to the imposition of an *ex ante* regulatory condition, as it ‘addresses the legality of a particular course of conduct’.¹⁴⁹ The CAT went on to state that in Article 102 assessments, a decision-maker is required to determine whether, having regard to all the circumstances, it is probable that that course of conduct will have the requisite exclusionary effect. However, in the present case (ie one relating to the imposition of *ex ante* regulation), the CAT said that it is ‘sufficient for Ofcom to demonstrate that, within the spectrum of pricing strategies that BT might realistically be expected to adopt, there are instances that constitute a price distortion’.¹⁵⁰
- 4.69 Given this, we have found that Ofcom did not err in seeking to distinguish between the requirements of competition law and *ex ante* regulation.

Our determination on reference questions 3(a), 3(b), 3(e) and 4(d): Alleged restrictive nature of the test

Our determination on reference questions 3(a) LRIC+, 3(e) bright line and 4(d): Evidence of exclusionary intention or adverse effects

- 4.70 We have assessed BT’s arguments on the individual elements of the test which it alleges are restrictive and the extent to which they demonstrate that Ofcom erred. Based on our assessment in paragraphs 4.30 to 4.42 and 4.56

¹⁴⁹ *British Telecommunications plc v Ofcom* [2016] CAT 3, paragraphs 123–133.

¹⁵⁰ *British Telecommunications plc v Ofcom* [2016] CAT 3, paragraph 128.

to 4.69, we determine that Ofcom has not erred in relation to reference questions 3(a) and 3(e).

- 4.71 In relation to reference question 4(d), given our findings on the proportionality of the bright-line test and our assessment in paragraphs 4.63 to 4.69, we determine that Ofcom did not err in excluding any requirement for evidence of either exclusionary intention or adverse effects on competition in the *ex ante* application of the Margin Condition.

Our determination on reference question 3(b): Monthly test

- 4.72 As to reference question 3(b), while we consider it was appropriate for Ofcom to apply a LRIC+ test that requires BT to contribute to its common costs across the portfolio, our view is that the requirement to make this contribution on a monthly basis is unduly restrictive. Further, we agree with BT that a one-month compliance period unnecessarily reduces its flexibility over the recovery of its common costs, and its ability to compete effectively. We find that, with the one month compliance period, Ofcom's design of the test went beyond its own stated aim in imposing such a remedy, ie to ensure that BT's competitors could profitably match BT's SFBB offers.
- 4.73 The one-month compliance period therefore appears to us not to comply with the requirement in section 47(2)(c) of the Act, in that the Margin Condition is not, in this regard, proportionate in relation to what it is intended to achieve. We have found that the concerns relating to risks to competition relied on by Ofcom do not justify the imposition of a one-month compliance period and, as a result, we consider that Ofcom has not properly demonstrated that its decision in this regard amounted to the least onerous means of achieving its stated regulatory aim. Although the scale of the impact of a one month compliance period is not capable of precise quantification, and BT did not provide any such quantification, we are satisfied that the error is material, given the unnecessary reduction in BT's flexibility over the recovery of its common costs and hence in its ability to compete effectively.
- 4.74 While we consider that Ofcom did not, for the reasons given above, err in its decision to (i) use a LRIC+ standard, and (ii) apply the test on a bright-line basis, we have come to the conclusion that it is the adoption of a one-month compliance period in this context that is unduly restrictive to BT.
- 4.75 In its response to our provisional determination, BT argued that in our provisional determination we had found that it was the combination of LRIC+, the monthly compliance period and the bright-line test which renders the Margin Condition unlawful in going beyond what is needed to address Ofcom's regulatory aim. BT argued that the scope of Ofcom's error could not

be reduced to an error in the length of the compliance period alone (and therefore could not be remedied by simply extending the length of the compliance period to make the effect of the Margin Condition less restrictive). BT's argument is premised upon a misreading of our provisional determination. We agree that the effect of the length of the period must be considered within the context of design of the Margin Condition as a whole, including the LRIC+ standard and the bright-line test. We have done so, as our provisional determination was intended to indicate. However, we disagree with BT that Ofcom erred in relation to its design of the Margin Condition more generally. To the contrary, we have found that Ofcom did not err in relation to its use of a LRIC+ standard and by implementing a bright-line test. Ofcom's sole error relates to its adoption of an unjustifiably short compliance period within that context. We consider that this error can be corrected without otherwise changing the substantive design of the Margin Condition, so as to result in a condition which is proportionate to Ofcom's regulatory aim overall.

- 4.76 In light of our assessment in paragraphs 4.43 to 4.55 and 4.72 to 4.75 above, we therefore determine that Ofcom erred in imposing a one-month compliance period.
- 4.77 For the purposes of reference question 5(d) (and for the avoidance of doubt), we consider that, when a more appropriate compliance period has been substituted for the one-month compliance period, the Margin Condition overall will not breach the principle of proportionality.

Reference questions 3(d) and 4(b): Average customer life

- 4.78 As explained in paragraphs 1.26 to 1.29, the Margin Condition broadly requires that the margin BT generates over the expected life of a new SFBB customer covers the initial acquisition costs. The estimate of the expected customer lifetime over which the assessment is made is therefore an important input in the calculation. This is referred to in the documentation as the ACL. The ACL is the period over which the ongoing monthly margin is generated by a customer before they are assumed to churn. The longer the period, the more profit will be generated.¹⁵¹
- 4.79 Ofcom set the ACL for the purposes of the Margin Condition at 60 months. This was based on its observations of the SBB churn rates of operators who

¹⁵¹ Assuming the ongoing net monthly margin of a customer is positive.

purchase the VULA wholesale product from BT, but did not take into account BT's own churn rates.¹⁵²

4.80 By reference question 3(d), BT challenged Ofcom's estimate of the length of the ACL and how it is used in the calculation. Specifically, BT alleged that Ofcom erred in:

(a) adjusting the ACL used in the Price Control to a period shorter than that for BT's own retail broadband customers; and/or

(b) using the shorter 60-month ACL throughout the control period.

4.81 BT has also raised a related concern in reference question 4(b), the application of an *adjusted* EEO standard, specifically that Ofcom erred on the facts of the present case by applying an adjusted EEO standard. In this case, Ofcom made two adjustments with respect to the length of the ACL and to bandwidth cost. As set out above, BT has challenged the length of the ACL in reference question 3(d) but BT has not challenged the adjustment to bandwidth costs. Therefore, we have considered reference question 4(b) alongside 3(d).

Ofcom's approach

4.82 In its Final Statement, Ofcom said that the need for a forward-looking ACL estimate, and the variability in the historical data, meant it was not appropriate to base the ACL on a specific historical average or a more complex calculation.¹⁵³ Instead, it exercised its judgement on the basis of general observations of the data available.

4.83 Ofcom decided not to use SFBB data to estimate ACL. This was because it considered that ACLs based on SFBB churn data were not a reliable or good indicator of the future ACL for SFBB customers.¹⁵⁴ As SFBB had only been relatively recently introduced, SFBB data was volatile due to the small sample base and ACLs might be distorted because they did not represent the level that could be expected in a competitive market. For example, Ofcom noted that many of BT's SFBB customers were still within the minimum contract

¹⁵² As stated in Ofcom defence, footnote 35, the formula which Ofcom uses to estimate ACL from churn data is: $ACL \text{ (in years)} = -0.25 / \text{LN} (1 - \text{quarterly churn rate})$.

¹⁵³ [Final Statement](#), paragraph 6.460.

¹⁵⁴ [Final Statement](#), paragraphs 6.443–6.449.

period, which would distort the churn-based ACL estimates towards a higher and misrepresentative level.¹⁵⁵

- 4.84 Ofcom concluded that SBB ACLs were a suitable proxy to use instead. This was because the retail SBB market appeared to be broadly competitive and Ofcom did not think that SFBB was so different that a higher ACL should be assumed.¹⁵⁶
- 4.85 Having decided to use historical SBB ACL as a proxy for future SFBB ACL, Ofcom considered whether it was appropriate to use BT's own ACL or whether an adjustment was needed. Ofcom implemented an adjusted EEO standard as part of its Margin Condition,¹⁵⁷ which involved using the vertically integrated firm's own costs, but making some adjustments to reflect advantages the firm may have.¹⁵⁸
- 4.86 The framework that Ofcom applied when considering potential adjustments to BT's own costs was a two-step test where both aspects needed to be met before an adjustment was made:¹⁵⁹
- (a) is there evidence that BT's costs/revenues materially differ from those of other operators; and, if so,
 - (b) is it likely that other operators could match BT's costs/revenues?
- 4.87 In considering the first of these steps, Ofcom found evidence of a material difference between the SBB ACLs of BT and those of other operators. In particular, it estimated that the ACLs of [redacted] were [redacted] than BT itself (eg between Q1 2011 and Q3 2014 BT's ACL was [redacted], while [redacted]).¹⁶⁰ Ofcom stated that Virgin Media's ACL figures ([redacted]) were not a good guide to the ACL of VULA-based operators, because Virgin Media's vertical integration made it easier for it to tailor its network to support its retail proposition. Further, switching between Virgin Media and other operators may have been more inconvenient for consumers than switching between providers that use the Openreach network.¹⁶¹

¹⁵⁵ [Final Statement](#), paragraph 6.444 states: 'In addition, many superfast broadband customers will still be within the minimum contact period, during which they are penalised if they switch to another operator.'

¹⁵⁶ [Final Statement](#), paragraph 6.446. Ofcom does not identify a separate SBB market; however, it uses the expression 'retail standard broadband market' in its arguments.

¹⁵⁷ [Final Statement](#), paragraph 5.33.

¹⁵⁸ [Final Statement](#), paragraph 5.12.

¹⁵⁹ [Final Statement](#), paragraph 6.57.

¹⁶⁰ [Final Statement](#), paragraph 6.452 & Table 6.9.

¹⁶¹ [Final Statement](#), paragraph 6.453.

- 4.88 Ofcom then considered the second step in its test and concluded that, on balance, it appeared likely that BT's higher ACL represented an advantage that other operators could not match.¹⁶² In doing so, it considered that the lower propensity of BT's broadband subscribers to churn could be a consequence of BT's position as the legacy incumbent. For example, Ofcom noted that BT's churning SFBB customers appeared disproportionately skewed towards those who had been with BT for a shorter length of time relative to its overall SFBB customer base.¹⁶³
- 4.89 Further, Ofcom said that alternative explanations for BT's higher ACL were not compelling¹⁶⁴ and that there was no evidence suggesting that BT had a consistently higher level of customer satisfaction relative to other operators. Ofcom also stated that there was no evidence that higher ACLs were the result of BT's offer of sport content. In coming to this view, it took into account that the difference in ACL between BT and other operators predated the launch of BT Sport and that other operators also offered sport content.
- 4.90 In its Final Statement, taking into account its conclusions that SBB ACL data was a suitable proxy and that the material difference between BT's ACL and other operators using its network was likely to be unmatchable, Ofcom concluded that it should assume a 60-month ACL.¹⁶⁵
- 4.91 Ofcom further concluded that, in order to provide BT with greater clarity around its obligations and certainty for other stakeholders, this 60-month ACL figure should form part of the proposed SMP condition. This was because this estimate relied on other operators' data which BT would not have access to on an ongoing basis.¹⁶⁶

BT's case

- 4.92 BT does not challenge that the costs and revenues in the Margin Condition should be applied over the expected life of a new SFBB customer. It does, however, challenge the assumed length of the life of a new SFBB customer, ie the ACL. Reference question 3(d) refers to paragraph 161(d) of BT's Amended Notice of Appeal which states that Ofcom erred in adjusting the ACL:

since (i) there is no proper basis for adopting a lifetime shorter than that for BT's own retail broadband customers and (ii) Ofcom

¹⁶² [Final Statement](#), paragraph 6.455.

¹⁶³ [Final Statement](#), paragraph 6.458 & footnote 782.

¹⁶⁴ [Final Statement](#), paragraph 6.456.

¹⁶⁵ [Final Statement](#), paragraph 6.466.

¹⁶⁶ [Final Statement](#), paragraph 6.467.

intends to use the artificially truncated 60-month ACL throughout the control period regardless of reductions to churn during that period.

- 4.93 BT said that its ACLs were higher than 60 months for both SBB and SFBB customers ([REDACTED]),¹⁶⁷ and that since 2011, [REDACTED] offering SFBB had had SFBB ACLs '[REDACTED]' than 60 months.¹⁶⁸ BT argued, therefore, that 'it would be reasonable to assume that they will have ACLs in [REDACTED] for the duration of this market review period'.
- 4.94 BT challenged Ofcom's approach on five grounds. These can be summarised as follows:¹⁶⁹
- (a) Ofcom was wrong to use SBB ACLs as a proxy for SFBB ACLs. In particular, whilst there may be [REDACTED] in the SFBB ACL data, the ACL for SFBB had consistently been higher than for SBB over an extended period. There was no reason to expect that SFBB ACLs would reduce to 60 months during the Price Control period and, by using an ACL based on the average of SBB for competitors, Ofcom had [REDACTED] in the form of [REDACTED].
 - (b) The impact on ACL of minimum contract periods, cited by Ofcom in its Final Statement as a distortion, would affect all CPs equally, so would not necessitate an adjustment. Similarly, the natural product lifecycle could result in elevated ACLs for a time following introduction, which again would affect all competitors without implying lower levels of competition. BT said that Ofcom's suggestion that SFBB ACLs could be expected to [REDACTED] to five years over the next 18 months was 'not only completely unevicenced but intrinsically implausible' in the circumstances.¹⁷⁰
 - (c) These errors would be compounded by Ofcom's requirement to recover all unrecovered costs over a rigid five-year period (particularly the investment BT is making in sport), without giving credit for the fact that these would reasonably lead to reduced churn rates and extended ACLs.
 - (d) Ofcom's assessment that BT might have an unmatchable advantage by virtue of its legacy subscriber base was 'pure conjecture'.¹⁷¹ BT said that Ofcom offered no evidence of this in relation to SBB or SFBB. BT noted

¹⁶⁷ BT AmNoA, paragraph 175. During the course of the appeal, BT said that it had wrongly characterised the [REDACTED] -month SFBB figure which in fact reflected [REDACTED]; BT hearing transcript (BT appeal), p86, comment A24. We also note that these figures do not appear to be the same as the estimates provided by Ofcom, which BT subsequently presented in evidence.

¹⁶⁸ BT AmNoA, paragraph 176.

¹⁶⁹ BT AmNoA, paragraphs 183–187.

¹⁷⁰ BT AmNoA, paragraph 185.

¹⁷¹ BT AmNoA, paragraph 186.

that [redacted] ACLs were consistently higher than five years, but that Ofcom had not used this SFBB data as a cross check on its conclusions. Further, Ofcom wrongly ignored the evidence that some other CPs' churn rates ([redacted]) were already lower than BT's and that churn rates for BT's [redacted] competitors were falling.

- (e) By using a fixed 60-month ACL, Ofcom excluded the possibility of reflecting evidence as to future increases in ACL during the market review period. BT noted that public announcements since the Final Statement confirmed that churn rates were improving for both TalkTalk and Sky. Ofcom's assumption that a five-year ACL would be appropriate throughout the market review period was therefore 'commercially unrealistic' and was another example of 'Ofcom's artificially static and rigid approach'.¹⁷² BT also said that Ofcom's approach to the ACL would oblige BT to price by reference to the 'lowest common denominator' (a 'worst economic operator' rather than EEO or REO standard) and this contributed to the 'margin umbrella'.

Our assessment of reference question 3(d) and 4(b): Average customer life

4.95 We have considered the points which BT raises in relation to reference question 3(d) by relating them back to the main decision points for Ofcom when assessing the appropriate ACL to use for the Margin Condition. Specifically these were:

- (a) the reliability of the SFBB churn data;
- (b) adjusting away from BT's ACL;
- (c) industry SBB ACL data;
- (d) evidence that SFBB ACLs are likely to be higher than SBB ACLs; and
- (e) the option to vary ACL during the Margin Condition period.

4.96 We address each of these in turn in the sections below, highlighting the points which BT raises which are relevant to each.

4.97 Reference question 4(b) specifically references the 'facts of the present case', and at its core submission hearing, BT clarified that 'the specific issues raised by [reference question 4(b)] overlap with the [reference question 3] point in

¹⁷² BT AmNoA, paragraph 187.

relation to average customer life'.¹⁷³ Therefore, reference question 4(b) concerns what BT describes as the 'specific justification' required for Ofcom not to use BT's own SBB ACL figures and therefore adjust the EEO standard.¹⁷⁴

The reliability of the SFBB churn data

- 4.98 As discussed above, in coming to its assessment of a 60-month ACL, Ofcom used SBB churn data and gave no weight to SFBB churn data. In this section, we consider BT's case that Ofcom was incorrect in this approach.
- 4.99 Estimating ACLs is inherently difficult, as it is trying to predict the behaviour of a cohort of customers a number of years in advance. BT accepts that 'it's not completely formulaic',¹⁷⁵ and a degree of interpretation may be required.
- 4.100 At its main party hearing, BT represented Ofcom's evidence of churn data as shown below:

Figure 4: Churn-based ACL estimates (in years) for both SFBB and SBB customers, for certain CPs

[✂]

Source: Charts presented by BT at BT hearing (BT Appeal).

- 4.101 BT's view is that the inferred results from this data indicate that SFBB ACLs are higher than for SBB.
- 4.102 In response, Ofcom emphasised that it was seeking to estimate the actual ACLs experienced by CPs, and used churn data in order to infer this. However, there are situations where the observed churn could be atypically low without ACLs actually having been lengthened (ie the churn-based estimates would not be a reliable indicator for ACLs). Ofcom concluded that this was a risk for the SFBB data, particularly due to:¹⁷⁶
- (a) observed levels of volatility in the data, particularly due to smaller sample sizes;
 - (b) the limited time series available (due to the relatively recent launch of SFBB), with unrealistic results from some of the earlier years (eg [✂]); and

¹⁷³ Core submission hearing transcript (BT appeal), p40, lines 4–7.

¹⁷⁴ BT AmNoA, paragraph 249.

¹⁷⁵ BT hearing transcript p38, line 4.

¹⁷⁶ [Final Statement](#), paragraph 6.444; Ofcom defence (BT Appeal), paragraphs 313–317.

(c) the distortive effect of a high proportion of customers being in their initial contract. Ofcom described that when a high proportion of customers are bound by their minimum contract period, churn rate will be reduced, while this would only have a limited (or no) effect on actual customer life.

- 4.103 We agree with Ofcom that the data appears volatile and that the limited time series means that a simple analysis of SFBB churn rates might not provide credible ACL estimates. These are points which would affect the reliability of the historical SFBB churn data as a reasonable indicator of expected SFBB ACLs during the review period.
- 4.104 In particular, it is relevant that the SFBB segment has been growing rapidly, with net additions of 1.8 million customers in 2014 (the most recent year of the ACL estimates), which is equivalent to a 34% year-on-year growth.¹⁷⁷ Where the market segment is growing this rapidly, ACL estimates based on churn rates are unlikely to be reflective of the true underlying ACLs. In a situation where a large number of new customers are being added relative to the existing base, this would result in lower levels of calculated churn without necessarily changing the ACL. This effect is particularly relevant when a large proportion of customers are still in their initial contract, and so have not had the opportunity to switch provider, which would further depress the levels of churn. Given the growth in the segment, and prevalence of customers in their initial contract, we consider it likely that any SFBB ACL estimates based on churn data would be systematically distorted upwards to an unrepresentative level.
- 4.105 We are not persuaded by BT's argument that Ofcom's SFBB data concerns are irrelevant or insignificant. BT simply states that small sample sizes are less of a concern than previously.¹⁷⁸ BT suggested at its main party hearing that the SFBB segment could be sufficiently well established to provide evidence from customers' behaviour which could suggest that the effect above does not in itself explain the observed gap between SFBB and SBB churn data.¹⁷⁹ We consider that BT did not provide persuasive evidence in support of its appeal that Ofcom's concern with regard to the reliability of SFBB data was not valid.
- 4.106 In our view, BT's point that SFBB ACLs could not be expected to [§] to five years over the next 18 months (stated in paragraph 4.94(b) above) is based on an incorrect premise that they are higher than five years now. We therefore

¹⁷⁷ Witness statement of David Matthew, Figure 3.

¹⁷⁸ BT core submission, volume 2, paragraph 138.

¹⁷⁹ BT hearing transcript, pp56–58.

consider that the data on SFBB churn would not need to [redacted] the five-year line¹⁸⁰ during the period of the Margin Condition. This is because we do not agree with BT's interpretation of the SFBB churn data that these SFBB figures are a robust representation of the underlying customer life which they are attempting to reflect.

4.107 We are also mindful that any effects that distort the SFBB ACL estimates, and drive concerns regarding their accuracy, would equally apply when considering their value as a cross-check against figures produced via other methods.

4.108 BT has not shown that Ofcom was wrong in its decision to place no weight on the SFBB churn data when estimating the appropriate figure for ACL. Nevertheless, there may be differences between the products and general trends in use of bundles within the market segments. In paragraphs 4.128 to 4.137 below, we consider whether Ofcom should have made an alteration for any of the commercial differences between SBB and SFBB in coming to its assumption for the ACL for the Margin Condition based on SBB data.

Adjusting away from BT's ACL

4.109 In applying its 'adjusted EEO' principle, Ofcom determined that BT had a [redacted] ACL than other CPs ([redacted]), and this could be a result of its legacy incumbent position. Therefore, Ofcom concluded that this difference was unlikely to be matchable by a hypothetical EEO, and so an adjustment was appropriate. In this section, we consider BT's case that:

(a) in making an adjustment away from BT's own ACL, Ofcom removed the benefits from BT's historical investment in its retail proposition [redacted]; and

(b) Ofcom did not sufficiently evidence that BT's higher ACL is due to an incumbency advantage, so making an adjustment was inappropriate.

4.110 Ofcom's initial observation that BT had a materially higher ACL than other CPs was based on the SBB data shown in Figure 5 below. In making this assessment, Ofcom considered that Virgin was not a good guide to the appropriate ACL, as it is structurally different to the hypothetical adjusted EEO which relies on VULA (eg due to Virgin's vertical integration, and the increased difficulty of moving on to or off its network vs Openreach).

4.111 Ofcom therefore focused on Sky and TalkTalk's SBB data, since these are the largest VULA-using CPs and hence Ofcom considered that they were a good

¹⁸⁰ BT hearing transcript, p39, lines 14–15.

comparator set. This led Ofcom to the conclusion that BT had a material advantage in ACL over its competitors.

Figure 5: SBB ACLs based on churn analysis

[✂]

Source: BT Amended Notice of Appeal, paragraph 178 (originally Ofcom Excel Spreadsheet – FAMR Outputs sheet).

4.112 When considering whether this advantage was likely to be matchable by another operator, Ofcom’s position was based on the principle that a legacy operator could have an incumbency advantage from ‘inert’ customers who are unlikely to switch, and so have longer ACLs. This is because these customers are more likely to be with the legacy operator, where no switch was ever made, than a competitor, where they will have had to have switched at least once.¹⁸¹

4.113 Ofcom supported this position by observing the following:

(a) The data on BT’s SBB churning customers appeared to be disproportionately skewed towards those who had been with BT for a shorter length of time (relative to BT’s overall SBB customer base). Ofcom interpreted this as indicating that there is a group of legacy customers who are strongly disinclined to switch and which would increase BT’s ACL.¹⁸²

(b) [✂].¹⁸³

(c) BT does not demonstrate consistently higher levels of satisfaction than its competitors which might have provided an alternative explanation for higher ACLs.¹⁸⁴

(d) BT’s higher ACL predates the introduction of BT Sport, and sports content is also available from other competitors (particularly Sky).¹⁸⁵

4.114 BT submitted that an incumbency advantage ‘was and is pure conjecture’, and that Ofcom had offered no evidence for such an assumption.¹⁸⁶ BT further submitted that the adjusted EEO standard meant that ‘Ofcom bore a significant burden of proof to demonstrate that such an adjustment was

¹⁸¹ Ofcom defence (BT appeal), paragraph 323.

¹⁸² [Final Statement](#), paragraph 6.457, footnote 782. [✂];

¹⁸³ [Final Statement](#), paragraph 6.455.

¹⁸⁴ [Final Statement](#), paragraph 6.456.

¹⁸⁵ [Final Statement](#), paragraph 6.456.

¹⁸⁶ BT AmNoA, paragraph 186.

needed',¹⁸⁷ and that it did not consider that this had been met. At its hearing, BT argued that customer satisfaction generated loyalty and led to it having a higher ACL than other VULA-using competitors.¹⁸⁸ It also referred to investments it had made, for example in routers, that had resulted in greater customer retention.¹⁸⁹ However, BT did not provide evidence in the pleadings that supported these assertions or any alternative explanation for its ACL being higher than other VULA-using CPs.

4.115 The adjusted EEO standard which Ofcom adopted is designed to remove any advantages which BT may have which a hypothetical competitor may be unable to match. This should avoid changes which are associated with commercial decisions (eg relative levels of investment). The evidential threshold against which Ofcom should have made this assessment would appear to be based on the following (emphasis added):

- (a) Final Statement¹⁹⁰ – Where there is evidence that BT's ACL materially differs from those of other operators; and, if so, where it is **likely that other operators could not match** BT's ACL.
- (b) The 2013 Recommendation¹⁹¹ – 'Where specific market circumstances apply, such as where market entry or expansion has been frustrated in the past, NRAs may make adjustments for scale to the SMP operator's costs, in order to ensure that **economic replicability is a realistic prospect.**'

4.116 There does appear, to us, to be an underlying logic that might lead a legacy operator to have an unmatchable advantage in ACL due to incumbency. Much of Ofcom's approach appears to focus on identifying other possible sources for BT's longer ACL, and in their absence, it concluded that this supported the view that incumbency could be the cause. This is, therefore, not a direct observation of proof of incumbency advantages itself, but inference from 'ruling out' of other specific factors which could cause, at least some of, the difference in ACLs. We agree that, to the extent that historical investments or commercial strategy have improved the ACL, it is likely this would also be seen in other ways, none of which either Ofcom or BT were able to identify.

4.117 In our view, BT has not demonstrated that Ofcom erred in adjusting away from BT's ACL.

¹⁸⁷ BT core submission, volume 2, paragraph 130.

¹⁸⁸ BT hearing transcript, pp45-46.

¹⁸⁹ BT hearing transcript, pp52-53.

¹⁹⁰ [Final Statement](#), paragraph 6.57.

¹⁹¹ [The 2013 Recommendation](#), paragraph 65.

Industry SBB ACL data

4.118 Since Ofcom was concerned that BT was likely to have an unmatched advantage in its ACL, Ofcom considered that a more appropriate measure for a hypothetical EEO was to use the other VULA-using CPs, [redacted]. This was not a specific mathematical calculation, but a regulatory judgement based on the evidence available, and Ofcom determined that 60 months was appropriate.¹⁹² In this section, we assess BT's case that:

- (a) in making an adjustment, Ofcom should not have discounted Virgin's ACL in its assessment of competitors' ACLs; and
- (b) Ofcom should have accounted for the observed upward trend in SBB ACLs.

4.119 In considering the appropriate choice of comparators for an estimate of ACL, Ofcom discounted Virgin's ACL from its comparison set. Virgin's ACL is [redacted]. As described in paragraph 4.87 above, Ofcom's rationale for rejecting the use of Virgin data was that its vertically-integrated structure, and greater difficulty of switching between networks, means it is not a good guide to what the ACL of operators that purchase VULA from BT, and hence an adjusted EEO, could achieve.

4.120 When considering whether there were any apparent trends in industry SBB ACL that would cause it to increase over the period, Ofcom observed that since 2012, [redacted]. Based on these observations, Ofcom did not recognise a general trend, and so did not consider that an upward adjustment was necessary.

4.121 BT does not appear to provide a specific argument for why Ofcom's concerns regarding Virgin's ACL were incorrect. Similarly, BT's original statements on the trends in industry SBB ACL appear to be based on generalised estimates from competitors' public statements rather than the confidential data presented in Figure 5. BT has not explained how Ofcom's interpretation of the more specific, and presumably more accurate, data is incorrect.

4.122 Although Ofcom did not use a specific calculation in deriving its 60-month ACL, we found it useful to set out straight averages of Ofcom's estimates for the CPs' ACLs (based on values from Figure 5 above):

¹⁹² [Final Statement](#), paragraphs 6.460 & 6.461.

Table 1: SBB ACLs in months (unweighted averages) for different groups of CPs [REDACTED]

Group of CPs	2011-14	Q1-Q3 2014
[REDACTED]	[REDACTED]	[REDACTED]

Note: [REDACTED].

Source: Final Statement, Table 6.9. Uses figures from '2011 to Q3 2014' column and 'Q1 to Q3 2014 column' converted to months and rounded.

4.123 We also consider it relevant that Ofcom did not include [REDACTED]. This indicates that, contrary to BT's assertions, Ofcom has not adopted a 'worst economic operator'/'lowest common denominator' approach.¹⁹³

4.124 Based on the data shown in Table 1 above, it appears that any changes to the assumptions of which CPs to include, or which time periods to use in respect of industry SBB data (excluding BT), would only have had a small impact on Ofcom's choice of 60 months.

4.125 On possible trends during the period, since Ofcom set the ACL at a fixed level throughout the control period, it implicitly represents the expected average for that time. If the ACL were to increase over this period, the average would be higher than that indicated by the current level.

4.126 We agree with Ofcom that the SBB ACL data in Figure 5 shows a mix of trends, with different CPs achieving a range of changes in performance over the time period. This implies that there is no clear industry trend. Although trends can vary significantly depending on the choice of start and end points, in this case, it appears that choice of the start and end date has little effect on the overall trends in ACL for most of these CPs.¹⁹⁴

4.127 In summary, we consider that BT has not shown that Ofcom's judgement of a 60-month ACL based on the industry data was incorrect.

Evidence that SFBB ACLs are likely to be higher than SBB ACLs

4.128 In the context of an adjusted EEO standard, it is appropriate to consider the expectations that a hypothetical EEO might have when assessing its investment decisions. In particular, there is a question whether an adjusted EEO would expect to achieve higher ACLs for new customers in the SFBB segment of the retail broadband market than is currently being achieved in SBB.

¹⁹³ BT AmNoA, paragraph 187.

¹⁹⁴ [REDACTED]; [REDACTED]; [REDACTED]; [REDACTED].

- 4.129 When using SBB ACLs as a proxy for SFBB, Ofcom concluded it was not reasonable to expect the SFBB ACLs in a competitive market to be above SBB, so did not make any adjustments to reflect the fact that these are representative of SFBB. In particular, Ofcom stated that churn and ACL are dependent on the *relative* level of customer satisfaction compared to alternative offers, as this drives switching, and not on the absolute level. It therefore concluded that even if there were higher levels of customer satisfaction associated with SFBB, this would not necessarily lead to longer ACLs.¹⁹⁵
- 4.130 BT stated that SFBB is associated with higher levels of customer satisfaction than SBB, and that this would translate to lower churn rates, and higher ACLs. It supported this by highlighting some statements from TalkTalk's third quarter statement from February 2014 (and an updated trading statement in May 2015) which indicated that customers taking additional products such as TV or fibre had higher levels of satisfaction, and lower levels of churn.¹⁹⁶
- 4.131 Notwithstanding issues about the robustness and reliability of SFBB churn data, at its main party hearing, BT stated that there was additional supporting evidence for SFBB customers having longer ACLs than SBB, including the following:
- (a) [redacted] than in SBB, indicating they are likely to have a longer ACL than SBB customers.¹⁹⁷
 - (b) BT's SFBB customers have a higher propensity to buy other products, which increases the ACLs.¹⁹⁸
- 4.132 We recognise that, in principle, there is a scenario in which higher levels of customer satisfaction could result in longer ACLs. For example, a customer may not be able to compare directly their broadband service with an alternative offer, or may be generally put off from switching due to associated risks or time requirements. In this situation, it may be reasonable to assume that if a customer were reasonably satisfied with the service they were receiving, they may be less willing to switch, even if an alternative offer would ultimately be better. This could imply that if the broadband products of all competitors improved (eg through the provision of SFBB), it could result in a lengthening of ACLs for each CP.

¹⁹⁵ [Final Statement](#), paragraphs 6.446 & 6.447.

¹⁹⁶ BT AmNoA, paragraph 188.

¹⁹⁷ BT hearing transcript p57, lines 2–18.

¹⁹⁸ BT hearing transcript, p45, lines 13–16.

- 4.133 However, there is another equally plausible scenario in which higher customer satisfaction would not lead to increases in ACL. For example, if there are major trigger points in a customer's life (eg the expiry of an initial contract), they may consider switching options at that point regardless of their level of satisfaction. If competitors' offerings have improved as much as the existing provider, and so appear equally attractive at this point, then switching behaviour may remain similar to the prior levels.
- 4.134 Even if there is a higher level of customer satisfaction with SFBB currently, this may not persist to the point that a customer considers switching. In particular, it is likely that the higher customer satisfaction stem from the fact that the higher speeds associated with SFBB result in greater performance (eg browsing, streaming videos etc). As consumer demands and expectations continue to increase (eg 4K streaming), the impact of these higher speeds on consumer satisfaction might be eroded removing any effect on ACLs.
- 4.135 Therefore, our view is that increased customer satisfaction cannot be assumed to result necessarily in increased ACLs.¹⁹⁹
- 4.136 Although BT's other examples of differences in the behaviour of SFBB customers (eg customer behaviour at key trigger points and bundling propensity) might provide a basis in principle for BT's case, BT did not provide evidence to support these assertions. It is also possible that the effects BT has asserted above could be due to the characteristics of early adopters of SFBB differing from those that have remained on SBB to date, and hence any increase in ACL may not be persistent during the life of the Margin Condition, as more people upgrade to SFBB.
- 4.137 In our view, BT has not demonstrated that Ofcom should have assumed higher ACLs for SFBB compared with SBB.

Option to vary ACL during the Margin Condition period

- 4.138 As well as making an adjustment away from using BT's ACL figures, Ofcom took a different approach here to many other parts of the Margin Condition by fixing the ACL at 60 months throughout the period. This differs from other areas where, as a result of its cohort approach, costs/revenues vary to reflect values for each particular cohort. For ACL, Ofcom has fixed the ACL figure between cohorts as well.

¹⁹⁹ BT hearing transcript, p55, line 17. BT concedes that there is no specific evidence on customer satisfaction and its relation to ACL.

- 4.139 In this section, we assess BT’s argument that the ACL should be allowed to change during the period, rather than being fixed in advance, in order to: (a) capture any ongoing market trends, and (b) reflect scale benefits and the effects of BT’s future investments.
- 4.140 In the Final Statement, Ofcom emphasised that fixing the ACL in advance provided BT with clarity around its obligations. In particular, BT would not have access to its competitors’ ACL data and so would be unable to gauge the magnitude of potential changes to the ACL figure.²⁰⁰
- 4.141 BT proposed an alternative approach in which Ofcom could periodically review the evidence for the ACL (eg annually), and set a figure for the following set of compliance periods based on this.²⁰¹ This would retain the clarity of obligations on BT, while ensuring that observed changes in ACL could be incorporated into the Margin Condition.
- 4.142 We agree that fixing the ACL in advance would have the effect of not taking into account any ongoing market trends over the period of the Margin Condition. However, the risk of not reflecting the trends would need to be balanced against the risk of including unrepresentative data. If changes in the estimated ACL is driven more by short-term market conditions and sampling volatility, then allowing changes over the period could simply result in a more volatile level of headroom, increasing the risk of unintentional and unforeseeable breaches.
- 4.143 We have previously considered the evidence that there is no single observed trend across the market in paragraph 4.126 above. Ofcom provided evidence of volatility in the form of BT’s quarterly SBB ACL, as shown in Figure 6 below. This shows that BT has experienced several temporary increases in its SBB ACLs which have reduced again afterwards.²⁰²

Figure 6: BT SBB ACLs based on churn analysis, quarter-on-quarter average in years

[✂]

Source: Based on Ofcom’s Defence (BT appeal), Figure 2.

- 4.144 Fixing the ACL for the period would not take into account specific factors (eg an increase in investment in products or service quality relative to competitors) that could increase BT’s ACL. BT has, through various methods, been investing in its consumer products in previous years. BT refers to the launch of sport content in August 2013 as an example of the use of

²⁰⁰ [Final Statement](#), paragraph 6.467.

²⁰¹ BT core submission, volume 2, paragraph 144.

²⁰² We note that monthly ACLs would be expected to show more volatility than the quarterly averages shown in Figure 6.

investment to increase ACL. This is given as an example in BT's pleadings on 'indirect monetisation' in relation to reference question 3(f).

- 4.145 We accept that if a single CP were to increase its level of investment (eg in sport content) whilst no others made any changes, the CP would have an improved product and its ACL would likely increase, compared to a counterfactual where no such investment was made. On the other hand, if multiple competitors were to increase their investment levels, the relative difference in their offers might not change substantially and so would not necessarily result in any change to ACL. As discussed in paragraphs 4.132 to 4.135, the likely actual changes would be more complex to predict. In practice, any effect would be dependent on the competitive response of other CPs which could mitigate, or entirely negate, the expected benefits through creating equivalent or greater improvements in their own products, as assumed by an EEO standard.
- 4.146 We view BT's proposed alternative approach to effectively be a regulatory mini-review, as it would not be an automated process given the judgement required in setting the ACL for an adjusted EEO. Ofcom commented that, when setting regulation, it is relatively common to estimate parameters at the start of period and not revisit them subsequently. This approach is particularly appropriate where such variables are volatile, and the risks are symmetrical.²⁰³
- 4.147 We consider that such a review would include a cost of implementation and increase uncertainty over the effect on the Margin Condition, in particular given that there may be practical implementation concerns which could complicate such an assessment (for example, if competitor ACLs were moving contrary to BT itself). It is unclear to us that BT has shown that the ACL is likely to change sufficiently in this time period.
- 4.148 We also note that the Margin Condition only remains in place until the end of March 2017, so any periodic review of the ACL would need to take place prior to this date. At most, there could be an additional two years' more data than Ofcom had at the time of publishing its Final Statement. BT's proposed annual review approach would have only provided a single year of additional data. Given the original concerns around the accuracy and volatility of the churn data, we consider that the time until the end of the Margin Condition would not provide sufficient new evidence for Ofcom to make a significantly more robust assessment of the ACL.

²⁰³ Ofcom hearing transcript (BT appeal), p36, lines 5–22.

- 4.149 In response to our provisional determination, BT reiterated its view that an ACL of longer than five years was fully justified. In particular, it noted the cumulative effect of what it characterised as three individual judgments:
- (a) **SFBB data** – our assessment of the use of SFBB data is discussed in paragraphs 4.98 to 4.108 above;
 - (b) **BT’s SBB data** – our assessment of the use of BT’s own SBB data is in paragraphs 4.109 to 4.117 above; and
 - (c) **Virgin Media data** – our assessment of the use of Virgin Media data is in paragraphs 4.118 to 4.124 above.
- 4.150 Our assessment of the SFBB data and Virgin Media data was that it was not reliable for use when estimating the length of the ACL for an EEO. We also concluded that Ofcom did not err in adjusting away from BT’s ACL. We therefore conclude that it was not wrong for Ofcom to exclude the use of this data in designing the Margin Condition, whether on its own, or as part of a cumulative assessment. Our assessment of BT’s arguments around the use of its own SBB data led us to conclude that Ofcom was not incorrect in moving away from these figures in order to reflect the use of an adjusted EEO standard.

Our determination on reference questions 3(d) and 4(b): Average customer life

- 4.151 BT has not shown Ofcom to have erred either in adjusting the ACL used in the Price Control to a period shorter than that for BT’s own retail broadband customers, or in using the shorter 60-month ACL throughout the control period. We therefore determine that Ofcom did not err in relation to reference question 3(d).
- 4.152 BT has not demonstrated that the facts of the case on ACL show that Ofcom erred by applying an adjusted EEO approach. We therefore determine that Ofcom did not err in relation to reference question 4(b).

5. BT Appeal: Reference questions 3(c), 4(a) and 5(a): Static approach

- 5.1 This section addresses reference questions 3(c), 4(a) and 5(a) which all relate to the alleged ‘static’ test applied by Ofcom. This assessment is also relevant to reference question 1, which alleges that Ofcom did not take ‘utmost

account' of the Commission's Comments that a 'dynamic, multi-period analysis'²⁰⁴ would be appropriate.

5.2 The questions relating to these grounds are as follows:

- (a) Reference question 3(c): Did Ofcom err in one or more of the following respects: in applying a static approach to the design of the Price Control, taking no account of reasonably anticipated future changes in margin across the ACL of the relevant customers, for the reasons set out in paragraphs 161(c) and 173 to 174 of the Amended Notice of Appeal?
- (b) Reference question 4(a): Did Ofcom err in not incorporating a prospective analysis as part of the Price Control imposed, for the reasons set out in paragraphs 241(a) and 242 to 246 of the Amended Notice of Appeal?
- (c) Reference question 5(a): Whether the terms of the Price Control are in breach of the principle of proportionality that is applicable to such conditions as a general principle of EU law and pursuant to Article 8(4) of the Access Directive, having regard to one or more of the following alternatives:²⁰⁵ (a) a discounted cash flow and effects-based analysis, allowing for the recovery of fixed investment costs (including the fixed cost of sports rights) over a longer time period, for the reasons set out in paragraphs 273(a) and 275-277 of the Amended Notice of Appeal.

5.3 Considerations relevant to the period of cost recovery are also relevant to (i) the treatment of BT Sport costs (see paragraph 6.1 onwards); and (ii) BT's case that Ofcom should have applied an approach which was consistent with its approach to the modelling in the Pay TV statement (see 6.194 onwards). We consider the treatment of BT Sport costs and Pay TV separately.

Ofcom's approach

5.4 The Margin Condition looks at the net present value (NPV) of a customer over their expected average lifetime.²⁰⁶ It compares the discounted value of the ongoing margin with the net upfront costs and is calculated monthly, on a per customer basis. This model is a Discounted Cash Flow (DCF) analysis, based on historical data only, not forecast data.²⁰⁷

²⁰⁴ [Commission's Comments](#), p6.

²⁰⁵ The other alternatives listed at reference question 5 relate to matters discussed in other areas: the value approach (reference question 5(b)); WMO (reference question 5(c)).

²⁰⁶ [Final Statement](#), paragraphs 6.10 & 6.11.

²⁰⁷ Ofcom defence (BT Appeal), paragraph 252. We note, however, that Ofcom states that forecasts are inherent in a DCF analysis.

5.5 The calculation is set out as follows, where P=monthly revenue, W=monthly wholesale costs, DC=monthly retail costs, UC=upfront costs, and UR=upfront revenue:

$$\text{NPV } \{P - (W + DC)\} \geq (UC - UR)$$

5.6 In summarising its case in its Core Submission Volume 1, BT noted that ‘all projected revenues and costs used within the test are measured on the basis of information available in the relevant monthly ‘compliance period’ and are then assumed to remain static for the duration of the assumed customer life’.²⁰⁸ Further, in referring to a ‘static’ approach at its main party hearing,²⁰⁹ BT clarified that it was referring to the constant margin assumed by Ofcom within the Margin Condition, ie the level of monthly revenue (net of wholesale costs and monthly retail costs) is assumed to be constant over the 60 months. In the rest of this section, we therefore use the term ‘static’ approach to refer to an approach which assumes a constant margin over the ACL.

5.7 Ofcom described its overarching principle as follows:

Our overarching principle, within the approach set out in paragraphs 6.16 to 6.17, is to use the best estimates based on the historical data for calculating a constant margin that is representative of the circumstances of the ACL.²¹⁰

5.8 The Margin Condition tests whether the ongoing monthly margin is sufficient to cover the upfront net acquisition costs on a customer-by-customer basis. The following inputs and adjustments to those inputs have the effect of the margin remaining constant over the life of that customer:

- (a) Retail revenues, wholesale costs and retail costs are based on per customer monthly figures converted to lifetime totals using the assumed five year ACL.
- (b) Upfront revenues are subtracted from upfront costs to produce a net acquisition cost per customer.

5.9 Ofcom stated that while its approach to assessing the VULA margin under current circumstances would not rely on forecasts of revenues and costs, it would take into account some known changes to revenues and costs over the

²⁰⁸ BT core submission, Volume 1, paragraph 33(3).

²⁰⁹ BT hearing transcript, p127.

²¹⁰ [Final Statement](#), paragraph 6.34.

ACL. Ofcom cited examples of known changes, such as monthly subscription prices charged, and the take-up of BT TV.²¹¹

- 5.10 Ofcom further stated that ‘under current circumstances, we consider that it is not appropriate to include changes that are subject to uncertainty (eg changes to unit costs) due to the drawbacks of relying on forecast data’.²¹² Further explanation of this is provided in paragraphs 5.31 and 5.51.
- 5.11 Ofcom emphasised the interrelated nature of some cost and revenue items which would make forecasts particularly challenging. It stated that, in relation to the other individual items that BT considered would exhibit downward cost trends, it considered that the overall impact on the VULA margin was unclear once other changes in costs and revenues were taken into account. It cited the example of the unclear relationship between bandwidth costs and bandwidth usage. It noted that while BT had highlighted examples of changes that, in isolation, might tend to reduce the VULA margin (eg falling costs), other parameters may change in a way that (in isolation) might tend to increase the VULA margin (eg call revenues may fall).²¹³
- 5.12 In the Final Statement, Ofcom set out the data sources it would use in the Margin Condition.²¹⁴ Ofcom stated that ‘when assessing BT’s compliance with SMP condition 14 in a particular month, we would seek to use the best available data. Where possible, we would use historical, audited data’.²¹⁵ Ofcom then listed the data sources on which it intended to rely: publicly available information (eg price lists), annual BT management accounts, and internal BT data.²¹⁶
- 5.13 During the Consultation, TalkTalk raised a concern that Ofcom’s proposed use of a variety of data sources from BT, including its management accounts and regulatory financial statements, may lead to inconsistencies.²¹⁷ Ofcom responded in the Final Statement that it was aware of this risk and that it was possible that BT would use this to its advantage when submitting compliance data. Ofcom explained that it would therefore use historical audited data in the first instance (such as BT Consumer management accounts) and would cross-check data from other sources that BT had provided.²¹⁸

²¹¹ [Final Statement](#), paragraph 6.19. Ofcom expands on its examples of known changes at paragraphs 6.80 & 6.103. These do not form part of BT’s appeal.

²¹² [Final Statement](#), paragraph 6.19.

²¹³ [Final Statement](#), paragraph 6.21.

²¹⁴ [Final Statement](#), paragraphs 6.30–6.35.

²¹⁵ [Final Statement](#), paragraph 6.30.

²¹⁶ [Final Statement](#), paragraph 6.30.

²¹⁷ [Final Statement](#), paragraph 6.31.

²¹⁸ [Final Statement](#), paragraph 6.33.

- 5.14 On certain BT Sport costs which are subject to seasonal fluctuations, BT proposed, during the Consultation, using annualised data for all BT Sport costs, except for sports rights and conditional access fees.²¹⁹ Ofcom stated that it would use historical averaged data covering periods of at least six months.²²⁰ Ofcom noted that if a step change had taken place in the months preceding or during the compliance period, averaged cost and revenue estimates that also reflected the months preceding that step change might no longer be representative of the actual costs and revenues after that change. In line with its overarching principle, Ofcom indicated that it would use historical data taken from a shorter period, namely the months after the change in question took place.
- 5.15 Ofcom stated that it recognised that the precise data sources and periods were matters of judgement; however, it provided guidance on the data sources and data periods that it considered were likely to be appropriate:²²¹
- (a) For costs relating to broadband, voice and BT TV (excluding BT Sport), Ofcom said it would generally use average monthly data (ie annual costs divided by twelve) derived from the latest available audited annual accounts. For certain costs, more recent data was readily available as they were derived on the basis of a charge per end user and volumes. For these cost items, Ofcom said it would use averaged monthly data derived from the previous six months.
 - (b) For revenues relating to broadband, voice and BT TV (excluding BT Sport), Ofcom said it would generally use prices and charges applicable during each compliance period. For certain revenue items that were likely to fluctuate from month to month, eg call revenues and out of package data revenues, Ofcom said it would use averaged monthly data derived from the previous six months.
 - (c) Ofcom said that as BT Sport was a relatively new business, data sourced from historical annual accounts may not be representative of the costs that should be used in a forward looking analysis. For BT Sport revenues and costs, Ofcom said it would use averaged monthly data derived from the previous six months except for revenues where it observed monthly revenues were growing over the previous six months.²²²

²¹⁹ [Final Statement](#), paragraph 6.31A.

²²⁰ [Final Statement](#), paragraph 6.35.

²²¹ [Final Statement](#), paragraph 6.35B.

²²² Ofcom sets out its detailed approach to calculating monthly revenues in the case where revenues are growing in paragraph 6.311.

BT's case

5.16 By reference question 3(c), BT criticised Ofcom's static approach to future margin changes across the ACL. This criticism related to the choice of inputs into the VULA margin model. BT's case was that Ofcom was wrong to apply a static approach to the design of the test, taking no account of reasonably anticipated future changes in margin across the ACL.²²³

5.17 BT's argument was that, while Ofcom recognised its static approach represented a simplification, Ofcom dismissed BT's concerns that a simplified approach was likely to lead to market distortions; this was a serious methodological error on Ofcom's part in that it failed to reflect the commercial realities of how BT's competitors would assess the incremental profitability of a SFBB customer:

BT's competitors would look to acquire customers where they provided incremental margin across their expected customer life. Among other things, other CPs would expect there to be (a) scope for increases in revenue through cross-selling (ie moving from dual play to triple play to quad play, upgrading the TV package and/or increased pay-per-view sales) and up-selling (ie offering faster SFBB speeds at a higher price) and (b) scope for future cost efficiencies. The effect is thus again artificially to inflate the required retail margin.²²⁴

5.18 BT submitted that the inputs to the test were all derived by direct reference to data relating to the month of acquisition, and that the test effectively assumed the margin calculated in the month of acquisition remained fixed for the 60-month customer life:

No account is taken of any movement in ARPU²²⁵ (eg due to price increases during the customer life), reductions in the prices of regulated wholesale access services (even where these are subject to CPI-X requirements), cost efficiencies or changes in unit costs as a result of changing volumes.²²⁶

5.19 BT also stated that its competitors:

²²³ BT AmNoA, paragraph 161(c).

²²⁴ BT AmNoA, paragraph 174.

²²⁵ Average revenue per user.

²²⁶ First witness statement of James Tickel (BT Appeal), paragraph 113.

- (a) would take a dynamic forward-looking view of the lifetime value of customers, reflecting likely changes to costs and prices and on the ability to extend product propositions during the customer life, when deciding the price at which to acquire or upsell SFBB to customers;²²⁷ and
- (b) reflecting this, when making investments to develop their SBB and/or SFBB portfolio capabilities, would take a long-term view of how the value of such investments might drive acquisition, retention (eg reduce churn), ARPU growth of the existing base (through upsell/cross-sell opportunities) and any operational cost efficiencies, when making investments to develop their SBB and/or SFBB portfolio capabilities. They would never have a limited focus on making sure their monthly cohort margin covered an entirely static view of accounting losses relating to those investments.²²⁸

5.20 Reference question 4(a) alleged an error in not incorporating a prospective analysis and reference question 5(a) alleges a breach of proportionality having regard to a DCF approach and effects-based analysis. We have taken into account the relevant paragraphs of the Amended Notice of Appeal which are referred to in these reference questions²²⁹ but are of the view that these reference questions do not rely on additional arguments and/or evidence to that which BT relied on in respect of reference question 3(c). BT appeared to accept this in its Core Submission Volume 1 and at its main party hearing.²³⁰

Our assessment of reference questions 3(c), 4(a) and 5(a): Static approach

5.21 The errors alleged by BT represent criticisms of assumptions within the Margin Condition, namely:

- (a) that the margin achieved from a new cohort of customers will be the same across the ACL; and
- (b) that the constant margin will be based on BT's historical data.

5.22 BT's case that Ofcom erred in adopting a static approach was pleaded broadly. BT argued that Ofcom had erred because it could have applied a 'dynamic' approach (reference question 3(c)), a 'prospective' approach

²²⁷ First witness statement of James Tickel (BT Appeal), paragraph 105a.

²²⁸ First witness statement of James Tickel (BT Appeal), paragraph 106.

²²⁹ BT AmNoA, paragraphs 241(a), 242–246; 273(a) and 275–277.

²³⁰ BT core submission, volume 1; BT hearing transcript, p127, lines 15-20.

(reference question 4(a)), or a 'DCF and effects-based approach' (reference question 5(a)).

- 5.23 BT stated that a DCF analysis should be used 'at the very least as a cross-check against findings based on historical data alone'.²³¹ At its core submission hearing, BT clarified its position, stating that such an approach should be included as part of a dual test: if BT failed the static test, the cross-check should be used to examine the reasons for the failure.²³² At its main party hearing, BT stated that such an approach would act as some cross-check, but did not provide further clarification.²³³
- 5.24 It is not clear to us that a cross-check would change the effect of the Margin Condition unless it superseded the underlying calculation. In other words, if a prospective analysis is used as a secondary assessment if BT fails the test under a constant margin approach, then it becomes the binding constraint on BT's pricing. The assessment of a DCF analysis as a 'cross-check' therefore implies that there would be a double hurdle.
- 5.25 In respect of reference questions 3(c), 4(a) and 5(a), we interpret BT's case to be that in modelling the revenues and costs assumed for each cohort of SFBB customers, Ofcom should not have assumed a constant margin. In other words, in the Margin Condition, the margin over the ACL should be based on forecasts, and therefore can be expected to change.
- 5.26 BT also contended that the form of the Margin Condition used by Ofcom failed to reflect the commercial realities of how BT's competitors would have assessed the incremental profitability of a SFBB customer. BT stated that its competitors would look to acquire customers where they provided incremental margin across their expected customer life, and provided specific examples relating to increased revenues through cross-selling and upselling, and scope for future cost efficiencies. We therefore consider this within the broad framework of using forecasts.
- 5.27 In its Amended Notice of Appeal, BT did not explain in detail how these alternative approaches (dynamic and prospective) would work in practice. BT criticised Ofcom for not taking into account 'reasonably anticipated' changes in margin within the Margin Condition, but it did not provide examples as to how Ofcom could have done so. BT did not, in our view, suggest a comprehensive alternative, within the Margin Condition framework, to how the modelling of revenues and costs should be undertaken for each cohort of

²³¹ BT AmNoA, paragraph 246.

²³² First witness statement of James Tickel (BT Appeal), paragraph 39.

²³³ BT hearing transcript, p31.

customers. However, BT did provide examples of revenue and cost items that could be modelled differently under the alternative approaches to the Margin Condition which it proposed in its pleadings and evidence. For example, it stated that Ofcom should have used forecast data, in order to reflect commercial reality better.²³⁴

5.28 In light of the above, we consider BT's case by reference to revenues and costs. Drawing on the assessment of these specific assumptions, we then consider the question of whether Ofcom has erred in its decision to use a constant margin assumption, by using BT's actual data instead of forecasts, within the Margin Condition. Finally, we consider Ofcom's case that whilst its constant margin approach was a simplification, it was the most appropriate approach available, given the practical and conceptual difficulties with implementing an approach based on forecasts in a retail market.

Revenues

5.29 Although revenues may change for a number of reasons, BT specifically relied in its pleadings on the increases in revenue from new cohorts of customers over the ACL through the widening of the scope of the bundles sold to those customers by:

- (a) cross-selling (ie moving from dual play to triple play to quad play, upgrading the TV package and/or increased pay-per-view sales); and
- (b) upselling (ie offering faster SFBB speeds at a higher price).²³⁵

5.30 At its main party hearing, BT mentioned further examples, in particular related to the prices paid for content. BT indicated that it would seek to increase the average ARPU over the ACL and indicated that it had introduced and increased charges for access to HD content. BT stated that it was a predictable fact that a high proportion of customers who were provided with HD TV free in year one would then pay for it in year two, and it was this kind of predictable change that BT thought should have been taken into account in a prospective approach.²³⁶

5.31 Ofcom considered the issues relating to a constant margin approach within the Final Statement. Ofcom considered that there were problems with identifying reliable forecasts. Ofcom identified two primary arguments against

²³⁴ First witness statement of James Tickel (BT Appeal), paragraph 113.

²³⁵ BT AmNoA, paragraph 174.

²³⁶ BT hearing transcript, p130.

the use of forecasts,²³⁷ which it repeated in its Defence. These are described in 5.51 below in more detail, but are summarised as the following:

- (a) The forecast will be derived from BT itself.
- (b) If BT is forecasting improved margins, this may be precisely as a result of the effects that Ofcom is seeking to avert through the Margin Condition, ie a weakening of the competitive market for SFBB over time.

5.32 These arguments made by Ofcom are both particularly relevant to revenues that, in retail markets such as SFBB, will be reliant on BT's choice of commercial strategy and the success of BT in gaining an improved market position over time.

5.33 Ofcom did use some forecasts in respect of revenues. It made some adjustments for certain revenue items, although not those BT suggested:

- (a) **Temporary discounts to subscription prices** – Ofcom stated it would make an adjustment to the headline monthly subscription prices to take into account loyalty/retention discounts which BT offered to certain customers (for example where there is a discounted price for the initial term (eg the first 6 months)), as it would be unreasonable to assume that the low initial price would persist for the entire ACL.²³⁸
- (b) **TV take-up** – Ofcom stated that it would make an adjustment to the levels of revenues and costs to account for the fact that a proportion of customers are likely to cease taking TV during the ACL.²³⁹

5.34 At BT's main party hearing, Ofcom indicated that it made the adjustment relating to temporary discounts to subscription prices because it reflected the contractual position, and that it was clear from the advertising.²⁴⁰ Ofcom also said that the modelling adjustment relating to TV take-up was carried over from a previous Competition Act case; that it did not receive any representations on it; and that the impact on the headroom was minimal (1p for the April 2015 compliance period).²⁴¹

5.35 Ofcom contrasted these adjustments with the example cited by BT in relation to HD TV. Ofcom indicated that it would not necessarily be consistent to make an adjustment to revenues in this case. It noted that BT's customers were not

²³⁷ [Final Statement](#), paragraph 6.18.

²³⁸ [Final Statement](#), paragraphs 6.19 & 6.80.

²³⁹ [Final Statement](#), paragraphs 6.19 & 6.103.

²⁴⁰ Ofcom hearing transcript (BT Appeal), p99.

²⁴¹ Ofcom hearing transcript (BT Appeal), p101.

contractually committed to taking HD in year two and therefore that this represented a different set of circumstances to an upfront discount.²⁴²

- 5.36 This example provided by BT and responded to by Ofcom at its main party hearing appears to us to be a good example of the case for and against the use of forecasts for revenues. Ofcom accepted that revenues per customer will not be constant in practice over the ACL. However, any changes to those revenues will depend on BT's choice of commercial strategy and the response of its SFBB customers to that strategy.²⁴³
- 5.37 This appears to us to be a principle that is applicable to all the categories of revenue forecast identified by BT, including upselling and cross-selling. We recognise that there are difficulties with forecasting such revenues. For example, there is no directly observable external benchmark. We therefore agree with Ofcom that this would have required the use of BT's commercial forecasts.
- 5.38 BT noted that Ofcom's approach was inconsistent with its approach to charge controls previously put in place by Ofcom, where Ofcom regularly used forecasts for a range of assumptions for both revenue and cost items.²⁴⁴ However, we consider that where revenue forecasts are largely dependent on BT's commercial strategy, these are therefore fundamentally endogenous to the effects of the Margin Condition. This is therefore different to the situation of a price control which requires the forecast of exogenous assumptions (eg externally driven market volumes) or efficiency targets.
- 5.39 The difficulty of projecting commercial forecasts would generally apply to the examples provided by BT. For example, upselling, or increasing revenues from new cohorts of customers requires projections of BT's commercial strategy and estimations of how those customers will respond to that commercial strategy. This is fundamentally a decision for BT. We consider that BT has not shown that Ofcom could have directly forecast such revenues based on sources of evidence external to BT.
- 5.40 We would expect that such forecasts could only be considered as part of a consistent commercial strategy. For example, at present, data provided by BT indicates that [REDACTED].²⁴⁵ We recognise that BT may develop its commercial

²⁴² Ofcom hearing transcript (BT Appeal), p100,

²⁴³ Ofcom hearing transcript (BT Appeal), p104.

²⁴⁴ BT AmNoA, paragraph 244.

²⁴⁵ Ofcom defence (BT Appeal), Volume 4, Tab 42 shows the difference in ongoing margin for a portfolio triple-play customer to be [REDACTED] higher than a portfolio dual-play customer. Over an ACL of 60 months, this is equivalent to £[REDACTED] additional value. This is less than the additional cost of acquiring that customer as a triple-play customer [REDACTED].

strategy over time, but it is not apparent how this could have been reasonably anticipated by Ofcom as alleged in BT's case.

- 5.41 Ofcom stated that any forecasts of changes in margin for each cohort of customers could relate to a VULA margin squeeze. Whilst this is speculative in respect of any individual effect projected by BT, it illustrates the risks associated with the use of forecasts in retail markets.
- 5.42 In summary, in assessing whether Ofcom erred in its decision not to change revenues over the Margin Condition period, we note that there are examples where revenues are likely to change over the period, such as HD. However, including changes in revenues within the Margin Condition would require the agreement of a forecast of BT's commercial strategy and the outcomes of that strategy over the ACL of new customers. This may, in itself, be related to the effects of the Margin Condition.

Costs

- 5.43 BT argued that Ofcom should have taken account of changes in costs over the ACL, which could be reasonably forecast by Ofcom and would change the margin from SFBB customers. BT mentioned the example of future cost efficiencies,²⁴⁶ although it does not set out specifically what they might be. At its main party hearing, it referred to CPI-X price controls on wholesale costs.²⁴⁷
- 5.44 Ofcom considered that there were problems with identifying reliable forecasts (see paragraphs 5.10 and 5.31). However, these would arguably be less difficult to overcome in the context of costs, where Ofcom could give greater weight to external benchmarks, such as changes in input costs.
- 5.45 The use of a constant margin assumes that there is no change in the relevant costs over the period, other than changes which are directly passed through to revenues, and therefore would result in a constant margin. We can broadly categorise costs as wholesale costs and retail costs. Wholesale costs, which indeed may be subject to efficiency savings, are likely to be passed through in retail prices. Ofcom said that in a competitive market, changes in costs are matched by changes in price as excess profits are competed away. It considered it appropriate to assume that the margin would be unaffected by such changes in input costs.²⁴⁸ In contrast, retail costs will be very difficult to

²⁴⁶ BT AmNoA, paragraph 174

²⁴⁷ BT hearing transcript, p131.

²⁴⁸ [Final Statement](#), paragraph 6.20.

forecast as they are dependent on BT's commercial strategy. At its hearing, Ofcom stated: 'what we are forecasting here are retail costs, and that's just harder than a lot of the wholesale forecasts that we do. It would involve a big exercise of judgement. There is a substantial risk we get it wrong.'²⁴⁹

- 5.46 In summary, in assessing whether Ofcom erred in its decision not to change costs over the period, we note that:
- (a) BT only provided one general example of a future cost efficiency in its pleadings (see paragraph 5.50 below), which in any case is likely to be passed through in retail prices in a competitive market, and therefore either will result in a constant margin or will require a separate projection of revenues; and
 - (b) including changes in retail costs within the Margin Condition would require the agreement of a forecast of BT's commercial strategy and the outcomes of that strategy over the ACL.
- 5.47 BT also provided examples of downward trends relating to the net cost of Sport. These are discussed separately, in paragraphs 6.50 to 6.61 below.

Overall approach of using historical data

- 5.48 Lastly, we have considered whether a forecast approach could be used in-the-round (recognising the limitations of forecasts described above) as opposed to using historical data. A summary of BT's position is that:
- (a) this approach was more consistent with the way the market works;
 - (b) it reflects how BT's competitors would assess the profitability of a SFBB customer; and
 - (c) it is the closest approximation to commercial reality.
- 5.49 A forecast approach is also contained in the 2013 Recommendation.²⁵⁰
- 5.50 We agree, in principle, that Ofcom's static approach represents a simplification, and may not necessarily be reflective of commercial reality. Both revenues (such as HD) and costs (such as wholesale charges) can be expected to change over the ACL. Ofcom itself acknowledged that this approach was a simplification.²⁵¹

²⁴⁹ Ofcom hearing transcript (BT Appeal), p103.

²⁵⁰ [The 2013 Recommendation](#), Annex II.

²⁵¹ [Final Statement](#), paragraphs 4.44–4.46.

5.51 Ofcom identified a number of practical and conceptual difficulties with making forecasts in the relevant retail markets:

(a) The practical difficulties are summarised as follows:

- (i) Producing reliable and robust forecasts would be challenging, leading to a significant risk of regulatory error; future costs and revenues may be interrelated and forecasting all the relevant parameters would be challenging.²⁵²
- (ii) Forecasts would have to be revisited for each compliance assessment.²⁵³

(b) The conceptual difficulties are as follows:

- (i) The primary source of the forecasts would be BT itself, leading to the risk that unreasonable forecasts would be used in order to skew the test in BT's favour.²⁵⁴
- (ii) Even if the forecasts relied on were accurate, a positive NPV result would not tell Ofcom whether positive margins were due to legitimate pricing or the exclusion of competitors (eg in the absence of competition in the future, BT could increase profitability by raising retail prices).²⁵⁵
- (iii) Greater flexibility risked undermining Ofcom's objective: Ofcom was concerned that the difficulties associated with a more flexible approach that relied on BT's costs and revenue forecasts would undermine the effectiveness of its regulatory remedy.²⁵⁶ Ofcom used the two examples in (b) (i) and (ii) above.

5.52 In our view, Ofcom exercised its regulatory judgement in deciding whether to use a forecast approach, recognising the difficulties set out above, or a constant margin approach, which it recognised to be clearly a simplification.

5.53 Our assessment of BT's examples of forecast revenue and cost changes is that, whilst it would be possible to use forecasts, it is particularly difficult given that the variables are interrelated. For example, changes in wholesale or sports costs will also affect revenues of both BT and other providers, and the effects on the margin will take into account both BT's and its competitors'

²⁵² Ofcom defence (BT Appeal), paragraph 278.

²⁵³ Ofcom defence (BT Appeal), paragraph 277.

²⁵⁴ [Final Statement](#), paragraph 6.18.

²⁵⁵ [Final Statement](#), paragraph 6.18.

²⁵⁶ [Final Statement](#), paragraph 7.152.

commercial strategies. This means, consistent with Ofcom's Defence (as referred to in paragraph 5.51(b)(ii) above), in this case it would be difficult to determine what forecasts are reasonable and distinguish between legitimate pricing or the result of distortions in competition, which Ofcom is seeking to prevent.

- 5.54 We have also considered BT's argument that Ofcom failed to take 'utmost account' of the Commission's Comments and the 2013 Recommendation about a DCF approach. Ofcom argued that UK national circumstances meant that a forward-looking, dynamic, multi-period analysis was inappropriate; and that whilst a new entrant would legitimately want to defer the recovery of certain costs if the demand for its services was expected to grow in the future, these were not the circumstances at the time of the Final Statement.²⁵⁷ We agree with Ofcom's reasoning here.
- 5.55 In coming to our determination on these reference questions, we have considered the question of whether BT's concerns, taken together, are sufficient to demonstrate that Ofcom was wrong in its decision to reject a forecast approach and to instead apply a constant margin approach.
- 5.56 Ofcom explicitly recognised that there were trade-offs:²⁵⁸

And we're not pretending that our static margin assumption is truly saying that none of these costs will change in the next five years, none of these revenues will change in the next five years. That's not the reason for adopting it. Rather, given the difficulties and complexity [...] particularly looking at the totality of the costs and the revenues, it's not obvious that that's a better or more reliable estimate [...] it is not obvious you are going to end up in a much better place than the static approach.

- 5.57 While Ofcom could have used a forecast approach, particularly in light of the fact that BT provided examples of why Ofcom's approach represents a simplification, Ofcom considered these alternatives. It used its judgement in coming to a conclusion that a constant margin approach was appropriate given the conceptual and practical difficulties in using forecasts.
- 5.58 In BT's response to our provisional determination, it raised two main points. First, it stated that the practical concerns had been overstated, and that they

²⁵⁷ Ofcom defence (BT Appeal), paragraph 526.

²⁵⁸ Ofcom hearing transcript (BT Appeal), pp104–105.

could be overcome by running sensitivities on key costs and revenues to identify the direction and scale of the simplified static assumptions.

5.59 We consider it relevant that:

- (a) accurate forecasts would have been difficult to make given the retail nature of the business;
- (b) forecasts would be dependent on decisions by BT in respect of its commercial strategy, which decisions are also dependent on the actions of BT's competitors, and therefore are not easy to forecast by Ofcom; and
- (c) changes in input costs, while more able to be forecast, would not feed through directly to changes in retail margin, as we would expect input costs to be reflected in both BT's and competitors' prices.

5.60 We therefore do not agree with BT that the practical concerns have been overstated. On the facts of the case, we consider that the direction and scale of any changes will be difficult to determine reliably in practice. We have considered these arguments in more detail in paragraphs 5.38, 5.39 and 5.45

5.61 Second, BT also stated that it challenged the conceptual concerns: that there was no reason to believe that an assumption of an improving monthly margin would reflect assumed reductions in future competitive pressures; that on the contrary all market players would make assumptions as to the scope to reduce the costs of supply to customers as well as the scope to drive higher ARPU; and that there was no reason why Ofcom could not scrutinise the reasonableness of such assumptions.

5.62 We consider that even though an improving monthly margin could be the result of reasons relating to reduced costs and higher ARPU, it might also be the result of reduced competitive pressures, so a conceptual concern still remains. We made these arguments above in paragraphs 5.31, 5.41, and 5.51.

5.63 More generally, the conceptual concerns need to be considered with the practical concerns. A forecast that margins would improve would rely on projections of either increasing revenues or falling costs within a competitive environment. The difficulties with relying on such forecasts are discussed in paragraph 5.59 above.

Our determination on reference questions 3(c), 4(a) and 5(a): Static approach

5.64 Having assessed BT's case, we conclude that it has not demonstrated errors of fact or law in Ofcom's adoption of a constant margin. We consider that

Ofcom weighed up the risks and benefits of different approaches and legitimately exercised its judgement in coming to the conclusion in its Final Statement that the appropriate approach was to adopt a constant margin for this control period. We therefore determine that BT has not demonstrated that Ofcom has erred in fact or law, or in the exercise of its discretion. With regard to the specific reference questions, we determine as follows:

- (a) **Reference question 3(c)** – Ofcom did not err in applying a static approach to the design of the Margin Condition.
- (b) **Reference question 4(a)** – Ofcom did not err by not incorporating a prospective analysis into the Margin Condition or for failing to recognise the importance of undertaking a prospective DCF analysis, at the very least as a ‘cross-check’ against its findings based on historical data alone. Just as Ofcom concluded that such a prospective analysis would not meet its regulatory aim, that conclusion would also apply to its use as a ‘cross-check’.
- (c) **Reference question 5(a)** – Ofcom’s decision not to use a DCF and effects based analysis in the Margin Condition did not breach the principles of proportionality.

6. BT Appeal: Reference questions 3(f), 3(g), 3(j), 4(c), 5(b), 3(h), 4(h) and 5(c): BT Sport

Introduction

6.1 In this section, we assess BT’s claims that Ofcom erred by including the net costs of the BT Sport channels in the Margin Condition. Specifically, BT argues that Ofcom erred:

- (a) by including the net costs of BT Sport in the Margin Condition on a basis that fails to take account of:
 - (i) the size of the costs and revenues under consideration;
 - (ii) evidence as to long-term trend and seasonality; and/or
 - (iii) the nature of competition in content markets and how this affects competition in SBB and/or SFBB (reference question 3(f));
- (b) in not making allowance for the long-term costs of entry BT faces in seeking to compete effectively in the provision of sport content (reference question 3(g));

- (c) in its treatment of BT Sport launch costs and marketing costs (reference question 3(j));
- (d) in the application of the LRIC+ cost standard to bundled services including BT Sport (reference question 4(c));
- (e) by rejecting an alternative value-based approach (reference questions 3(i) and 5(b)); and
- (f) in adopting an approach which was inconsistent with the approach taken in Ofcom's Pay TV statement and/or discriminated unduly against BT (reference questions 3(h), 4(h) and 5(c)).

6.2 We first consider BT's case on reference questions 3(f), 3(g) and 4(c), having regard to our assessment of BT's argument on the static approach (see Section 5). We then consider BT's reference question 3(j) on the treatment of launch and marketing costs. Finally, we consider BT's proposed value approach and BT's arguments relating to Ofcom's approach in the Pay TV statement.

Ofcom's general approach

6.3 Ofcom's approach to the treatment of BT Sport in the Margin Condition is set out in various places in the Final Statement, in particular in Section 6.²⁵⁹

6.4 In calculating the VULA margin, Ofcom includes the net cost of BT Sport relevant to the compliance period as a cost to be recovered proportionately from SFBB customers. The net cost of BT Sport is the difference between the total cost of BT Sport and BT's direct revenue from providing BT Sport content. Monthly costs and revenues are derived as follows:

- (a) Ofcom calculates BT's total cost of providing its sports content on a LRIC+ basis, in a similar way to other costs. BT's total cost includes the costs of acquiring rights, which are spread evenly over the duration of the rights period, and ongoing costs. Ongoing costs include programming, production, transmission, distribution and SG&A costs. Ofcom takes the average cost for the six months up to the compliance month. Ofcom also includes an allowance for initial launch costs which are spread over the five years from 2013/14 to 2017/18.

²⁵⁹ [Final Statement](#), paragraphs 6.234–6.401. Ofcom's approach to BT Sport is considered at paragraphs 6.234–6.401. Paragraphs 6.268–6.314 provide an overview of Ofcom's analysis, and paragraphs 6.355–6.401 provide a detailed discussion of Ofcom's estimation of net costs.

- (b) Direct revenue is revenue from:
- (i) BT's direct sale of its sports channels;²⁶⁰
 - (ii) wholesale sales (to Virgin Media and Setanta Ireland);
 - (iii) advertising on BT Sport channels; and
 - (iv) subscription revenues from pubs and clubs broadcasting BT Sport channels (commercial revenue).

For direct revenue, Ofcom takes the average for the six months up to the compliance month, unless revenue is growing in which case it takes the figure for the compliance month.

- (c) The net cost (total cost less direct revenue) is then divided between SBB and SFBB customers according to the number of BT Sport users.²⁶¹ The net cost (in £ million) allocated to SFBB customers is then spread equally across all SFBB customers to give the net cost per SFBB customer. This figure is assumed to apply to the new cohort of customers in each month.

The cost of sports rights

6.5 BT's payments for the rights to broadcast FAPL and UEFA matches account for a large proportion of BT Sport costs. In its Final Statement, Ofcom identified two high level considerations in its treatment of these costs, which were:

- (a) whether BT has incurred overall losses such that part of the rights costs should be written off; and
- (b) the timing of recovery of costs that are not written off – for example, fewer costs might be recovered in the short term and more in the future if the profitability of BT Sport is expected to increase in future.²⁶²

Write-offs

6.6 In its Final Statement, Ofcom stated that:

²⁶⁰ This represents subscription and provisioning revenue from sales over Sky's platform and also revenue from sales of BT Sports channels to BT and Plusnet customers.

²⁶¹ [Final Statement](#), Annex 3, paragraph A3.60. BT Sport users are those who (i) have an active BT Sport connection (ie meet requirements to watch these channels without taking further action) and (ii) pay a discounted price for BT Sport (relative to non-BT broadband subscribers) or receive it for 'free'.

²⁶² [Final Statement](#), paragraph 6.278.

- (a) it is appropriate to focus on actual costs and revenues incurred and there is a very high threshold for departing from that approach. Adjusting costs to compensate for downside risks is not appropriate since BT was aware of these risks when it bid for the rights;
- (b) it did not consider it could place strong weight on documentary records of BT's business plans to make cost adjustments; and
- (c) in any case, the evidence submitted to Ofcom did not appear to support strongly BT's claim for a write-off.²⁶³

Timing of cost recovery

6.7 Ofcom stated the following:

- (a) It accepts as a matter of principle that where a new business expects its profitability to increase, it may be appropriate to defer the recovery of some costs. However, in the present case this is inappropriate because:
 - (i) BT has developed BT Sport largely to support its broadband business and BT is currently the largest retail provider of broadband in the UK; and
 - (ii) BT earns substantial direct revenue from the other CPs, launched its TV business in 2006 and BT Sport in 2013, and has already had the opportunity to build the scale of its current sports business.²⁶⁴
- (b) Since BT has developed BT Sport largely to support its broadband business, adjusting the profile of cost recovery to reduce the cost of BT Sport (and thus the minimum VULA margin) in the short term to reflect future profitability risks enabling precisely the distortion of competition that the Margin Condition is seeking to prevent. In practice, it is extremely difficult to distinguish between legitimate and illegitimate growth in the future profitability of BT's SFBB business.²⁶⁵
- (c) Relying on uncertain forecasts would introduce forecasting errors into the Margin Condition and/or create incentives for regulatory gaming. For example, BT would have the incentive to submit over-optimistic profit/revenue forecasts to reduce net costs.²⁶⁶

²⁶³ [Final Statement](#), paragraph 6.289.

²⁶⁴ [Final Statement](#), paragraph 6.292.

²⁶⁵ [Final Statement](#), paragraphs 6.292B and 6.293–6.295.

²⁶⁶ [Final Statement](#), paragraphs 6.296 and 6.301.

- 6.8 Ofcom did not therefore include any adjustments to BT Sport costs in its guidance on the calculation of the Margin Condition issued with its Final Statement.

Supplementary Guidance

- 6.9 In August 2015, Ofcom accepted that BT's acquisition of UEFA rights and launch of its UEFA channels²⁶⁷ represented a material change in circumstances, and issued the Supplementary Guidance.
- 6.10 In the Supplementary Guidance, Ofcom allowed for sales of BT's UEFA channels building up over time. The Supplementary Guidance sets out a modified treatment for BT's UEFA channels. Ofcom allows a deferral period of 12 months (August 15 to July 16) when the incremental net costs of the UEFA channels²⁶⁸ are excluded from costs for the margin calculation; then a nine-month recovery period (August 16 to April 17) when the compounded present value, if any, of cumulative shortfall²⁶⁹ during the deferral period has to be recovered.²⁷⁰
- 6.11 The Supplementary Guidance also included the following statement:

BT also requested additional guidance in relation to how we would assess a failure of the VULA margin test as a result of a 'commercial failure' of a significantly changed or new proposition and/or falls in sales caused by retail initiatives by its competitors. In the event that the actual circumstances surrounding the UEFA Channels were to develop in an exceptional way, including in respect of commercial failure, we may need to reassure ourselves that the application of our guidance remains appropriate.²⁷¹

²⁶⁷ Ofcom defines the UEFA channels as all BT Sport channels except BT Sport 1. BT has exclusive rights to broadcast UEFA matches for three football seasons, 2015/16 to 2017/18.

²⁶⁸ It is not clear how the incremental net costs of the UEFA channels are calculated.

²⁶⁹ [Ofcom Supplementary Guidance](#), paragraph 2.66. Shortfall is the difference in any month of the deferral period between (i) actual revenue and (ii) minimum revenue under the Margin Condition including UEFA channels.

²⁷⁰ [Ofcom Supplementary Guidance](#), paragraphs 2.65 & 2.66. The amount to be included seems to be the levelised monthly charge that recovers the shortfall but the shortfall is recalculated each month to reflect the minimum margin under the Margin Condition if greater than actual margin.

²⁷¹ [Ofcom Supplementary Guidance](#), paragraph 2.69.

Reference question 3(f): Treatment of BT Sport costs

BT's case

- 6.12 BT stated that the effect of Ofcom's approach to the net cost of BT Sport was potentially arbitrary, in that it means customers in different monthly cohorts might be required to make very different contributions towards the costs of supply of the BT Sport channels even though each cohort is being provided with access to the same BT Sport channels and therefore access to precisely the same content across their customer life. BT said that the only difference was that the accounting losses of providing those channels might be different in their month of acquisition.²⁷²
- 6.13 BT submitted that those monthly differences did not reflect any change in underlying conditions of competition but arose from the following variations from month to month:
- (a) The accounting losses in an individual month depend on monthly costs and revenues which are significantly affected by seasonality. (These are not eliminated by Ofcom's application of a six-month rolling average, since certain costs are still significantly variable across the full year.)
 - (b) Where a substantial new rights cost is added by Ofcom, for example BT's UEFA content which has been transmitted since August 2015, the effect is to increase the monthly costs substantially, but there will not necessarily be an immediate or consistent correlation to increased revenues. This might be the case with the UEFA content particularly, as the content varies significantly in its attractiveness to viewers over the term of the competitions.
 - (c) Monthly revenues of BT Sport show an upward trend over time as the result of various factors, including steadily increasing the number of channel-only subscribers and, from the start of the 2014/15 season, the end of the initial free HD offer.
 - (d) BT's SFBB customer base is growing steadily, and the mix of SBB and SFBB subscribers is moving towards SFBB.²⁷³
- 6.14 BT submitted that the net effect of these factors was that:

²⁷² BT AmNoA, paragraph 198.

²⁷³ BT AmNoA, paragraph 199.

- (a) there is a general downward trend in the net costs of BT Sport per SFBB subscriber; but
- (b) there will continue to be seasonal variation across the year within that downward trend.²⁷⁴

6.15 BT said that, consequently, Ofcom's approach to the design of this aspect of its margin squeeze test means:

- (a) that the test as a whole provides little, if any, information on whether BT's competitors can compete effectively in the supply of SFBB bundles; and
- (b) that it simply acts to place disproportionate restrictions on BT's freedom to develop retail products incorporating its BT Sport channels, and to set fair and competitive prices.

BT submitted that the only way in which it could avoid the possibility of breaching the Margin Condition in any individual month would be to take a very conservative approach to its pricing, further aggravating the distortive effect of the Margin Condition.²⁷⁵

6.16 In support of this BT referred to other parts of its pleadings and evidence relating to the alleged, perverse effects arising from Ofcom's treatment of BT Sport in the Margin Condition, and in summary made the following points about how Ofcom's treatment of BT Sport in the Margin Condition hindered BT's ability to compete:²⁷⁶

- (a) It increased the incentive of BT's rivals to 'cream-skim', ie to exploit the different valuations that customers purchasing BT's bundles would have of the different products and thereby to force BT to increase the prices of its bundles. BT alleged the 'perverse and bizarre' effect of the Margin Condition was that, as a result of an increase in competition in the retail market resulting in a loss of customers by BT, BT could be forced to increase its retail prices or reduce its wholesale prices, thereby likely precipitating further loss of customers to inefficient competition and so on in a downward spiral. While BT could respond to 'cream-skimming' by unbundling its BT Sport product from its SFBB offers, BT said that this would also restrict or distort its ability to compete in a sector in which Ofcom recognised that triple-play bundles were an important and growing proportion of SFBB sales. BT considered that the effect would therefore

²⁷⁴ BT AmNoA, paragraph 200.

²⁷⁵ BT AmNoA, paragraph 201.

²⁷⁶ BT AmNoA, paragraph 262; Witness Statement of John Petter, paragraphs 89–100; RBB report, Section 5.

be to place an artificial restriction on BT's ability to recover the costs of its investment in a manner that would be open to its competitors.

- (b) The effect of Ofcom's approach was to hamper BT's ability to monetise assets with variable pay-offs, restricting the options available to BT to recover its investment in profitable sports rights.
- (c) Ofcom's approach had the further effect of restricting BT's ability to compete in markets for sports rights. By depriving BT of the opportunity to recover on a 'commercially rational' basis its costs of investing in its Pay TV business, Ofcom's approach operated as an effective barrier to entry against those seeking to challenge Sky's entrenched position both upstream and downstream in that sector. Ofcom's regulation would therefore restrict competition on unrelated markets for the acquisition of sports rights.
- (d) Ofcom's approach distorted incentives to make risky investments, again exemplified by future sports rights acquisitions. If the risk were to eventuate such that BT would fall short of covering the investment costs it incurred, the perverse result of including BT's net sport costs in the VULA margin requirement would be that BT would be forced to increase its retail prices or to decrease its wholesale price of its SFBB services. BT submitted that would be a wholly uncommercial response that would be likely to lead to even further losses. BT stated that Ofcom's approach had the 'bizarre effect that the retail price BT is allowed to set may be inversely correlated to the value of its services'.

6.17 BT also submitted that this error further compounded the general errors it had alleged: the static, monthly, bright-line application of the test and the rigid approach to the recovery of costs that were not directly driven by the different monthly cohorts of new customers. In BT's view, the treatment of BT Sport provided a 'vivid' illustration of those errors.²⁷⁷

6.18 BT further stated that these errors were accentuated in the context of Ofcom's treatment of BT Sport costs by:

- (a) the size of the costs and revenues under consideration;

²⁷⁷ BT AmNoA, paragraph 202.

- (b) the rigidity of Ofcom’s approach despite clear evidence as to the long-term downward trend and short-term seasonality of the net costs of BT Sport; and
- (c) the absence of what BT would regard as a proper assessment of the nature of competition in content markets and how this impacts competition in SBB and/or SFBB, in particular between BT and Sky.²⁷⁸

6.19 In its Core Submission Volume 1, BT reiterated its arguments about the absence of a relationship between the monthly net costs of BT Sport and the cohort of new customers. It submitted that the [redacted] of the monthly net costs of BT Sport included within the Margin Condition was not driven by the cohort of new customers added in that month – these included the costs of rights, programming, production and transmission. BT stated that, while the test in April 2015 required that the new cohort contributed £[redacted] to sports costs in each month of the 60-month customer life, the flow of new SFBB customers considered within the monthly compliance period was [redacted] per customer, on average, to the costs of operating the channels.²⁷⁹

6.20 BT accepted that the Supplementary Guidance allowed it to depart from the ‘standard’ guidance set out in the Final Statement. BT noted, however, that to the extent it took advantage of the additional 12 month flexibility, it would then be required to earn additional monthly margin on acquired monthly SFBB cohorts during the nine months from August 2016 to make up the net shortfall in the previous 12 months.

6.21 BT submitted that, while Ofcom had provided some flexibility in the operation of the test for a limited period, to the extent BT used such flexibility, it could face additional and rigidly-applied requirements to earn margin on subsequent cohorts of acquired SFBB customers. BT stated that any such increased requirements would ignore the extent to which any net shortfall in the first 12 months may have been covered by margins on other broadband customers (ie the base of SBB and SFBB customers) in those 12 months. BT submitted therefore that its general concerns with Ofcom’s approach to the recovery of the fixed costs of BT Sport had not been addressed by Ofcom issuing the Supplementary Guidance.²⁸⁰

²⁷⁸ BT AmNoA, paragraph 203.

²⁷⁹ BT core submission, volume 1, paragraphs 46–51.

²⁸⁰ BT core submission, volume 1, paragraphs 57 & 58.

Our assessment of reference question 3(f): Treatment of BT Sport costs

6.22 There are three limbs to this reference question. First, that Ofcom failed to take account of the size of the costs and revenues under consideration. Second, that Ofcom failed to take account of the long-term trend and seasonality of the net costs of BT Sport. Third, that Ofcom failed to take account of the nature of competition in content markets and how this would affect competition in SBB and/or SFBB, in particular between BT and Sky. In its response to our provisional determination, BT said that the features identified in the first two ‘limbs’ of this question gave rise to the concern raised in the third.²⁸¹ We deal with each in turn taking into account the relationship between each ‘limb’ in our overall assessment of reference question 3(f).

Size of the revenues and costs

6.23 We consider first Ofcom’s rationale for taking into account the costs and revenues of BT Sport in the Margin Condition before addressing BT’s specific point about their size.

6.24 Ofcom considered BT Sport to be relevant to the Margin Condition because it was bundled with BT’s SFBB products.²⁸² BT’s sports channels have either been offered to its SFBB customers for no additional charge, or for a price that is well below that which BT charges to customers who do not have BT broadband.²⁸³

6.25 Ofcom concluded in its Final Statement that the costs and revenues of bundled elements, such as BT Sport, should be included when assessing the VULA margin.²⁸⁴ It provided three reasons for doing so:

- (a) Retail competition in SFBB occurs between different bundles and both BT and other CPs supply bundles of services. Therefore to achieve its regulatory aim, any assessment must consider whether an adjusted EEO is capable of matching the price BT charges for its bundles.

²⁸¹ BT response to our provisional determination, paragraph 74.

²⁸² [Final Statement](#), paragraph 5.85 and 5.89–5.94.

²⁸³ At the time of the Final Statement (March 2015), BT made no charge to BT broadband customers for BT Sport channels while BT’s charge to other customers via the Sky platform was £13.50 per month. In both cases receiving the channels in HD cost £3 extra. In January 2016, BT still made no charge to BT broadband customers for the BT Sport 1 channel but it had introduced a charge for the other BT Sport channels (which include UEFA content) of £5 per month (with an additional £4 charge for HD). In January 2016, BT’s price to other customers via the Sky platform was £19.99 per month for an annual contract and £23.99 for a monthly contract – these charges covered all BT Sport channels. Note: figures quoted here relate to the BT brand; charges for the Plusnet brand are higher.

²⁸⁴ [Final Statement](#), paragraph 5.85.

- (b) If the costs and revenues of bundled elements were not included, the effectiveness of the Margin Condition would be undermined. By offering bundled elements at less than their costs, BT could effectively offer a discount and an adjusted EEO may be unable to match the price of BT's overall bundle even if BT's margin on the superfast element was notionally positive.
- (c) The non-broadband elements included in bundles did not always have a readily identifiable price and the effectiveness of the Margin Condition would be at risk if the price of the SFBB component was estimated incorrectly.
- 6.26 During the Consultation, BT argued that BT Sport should be entirely excluded from the assessment.²⁸⁵ Although, in some respects, BT made similar arguments in this appeal, it did not explicitly argue in its Amended Notice of Appeal that these costs should be entirely excluded. Indeed, parts of its case before us appear to accept that they should be taken into account.²⁸⁶
- 6.27 Nevertheless, for the avoidance of doubt, our view is that, given BT has taken a commercial decision to include its BT Sport channels in its broadband bundles, BT Sport should be taken into account in the Margin Condition.
- 6.28 The first limb of reference question 3(f) alleges that Ofcom erred by including the net costs of BT Sport on a basis that fails to take account of the size of the costs and revenues under consideration. While we recognise that the effect BT Sport will have on the VULA margin depends on the size of the net costs involved, we do not read in the pleadings cited in support of this reference question specific arguments as to how Ofcom failed to take into account the *size* of these net costs.
- 6.29 In our view, therefore, BT has not demonstrated its claim under the first limb of question 3(f) that Ofcom failed to take account of the size of the costs and revenues of BT Sport.

Long-term trend and seasonality of the net cost of BT Sport

- 6.30 BT considered the monthly differences in the contribution required to be made by each cohort towards the cost of supply of BT Sport channels and alleged that these differences did not reflect any underlying conditions of competition but arose from:²⁸⁷

²⁸⁵ [Final Statement](#), paragraphs 5.89–5.96.

²⁸⁶ BT hearing transcript, pp96–97.

²⁸⁷ BT AmNoA, paragraph 199; First witness statement of James Tickel (BT Appeal), paragraphs 117–154.

- (a) seasonal effects;
- (b) timing differences between the costs and revenues of BT Sport when a substantial new rights cost was added;
- (c) an upward trend in the monthly revenues of BT Sport; and
- (d) a change in the mix of SBB and SFBB customers and growth in the SFBB customer base.

6.31 We consider BT's points on seasonality and timing differences. We then assess BT's arguments about trends in BT Sport net costs and revenues together with the impact of changes in the mix of SBB and SFBB customers.

Seasonality

6.32 As we summarise in paragraph 6.13, BT argued that net costs in any individual month were significantly affected by seasonality and this was not eliminated by Ofcom's application of a six-month rolling average. This was because, BT argued, certain costs were still significantly variable across the full year.²⁸⁸ Ofcom stated that it decided to use historical averaged data derived from the previous six months which eliminated a significant part of the month-on-month changes to BT Sport costs and revenues.²⁸⁹

6.33 We understand the parties to be agreed that Ofcom's approach does not eliminate *all* variation in BT Sport costs. We consider which particular costs vary and are not fully smoothed before assessing the parties' respective arguments about the implications of the residual variation.

6.34 We have looked at the available cost and revenue data²⁹⁰ and considered the sports costs that appear, or are alleged, to be seasonal. We found that the main sports costs that varied seasonally were marketing costs.²⁹¹ Figure 7 suggests marketing costs per customer are highest for July to September, around the start of the football season.²⁹²

Figure 7: BT Sport marketing costs (£ per SFBB customer)

[✂]

²⁸⁸ BT AmNoA, paragraphs 198 and 199(1).

²⁸⁹ [Final Statement](#), paragraphs 6.34–6.35.

²⁹⁰ Ofcom defence (BT Appeal), Volume 4, tabs 39 & 41. This is the data provided by BT to Ofcom and submitted to us by Ofcom.

²⁹¹ [✂].

²⁹² Ofcom defence (BT Appeal), paragraph 380. Ofcom raised two specific points about BT's historical numbers: that they may be affected by initial launch costs and by accounting adjustments (These points do not affect the marketing data in Figure 7).

- 6.35 Figure 7 also suggests there is seasonal variation in marketing costs per customer which is unlikely to be removed by six-monthly smoothing. Six-monthly smoothed costs will tend to be highest for September to December when all three months of high marketing expenditure are included.²⁹³ The smoothed costs will be lowest for March to June when none of the three months of high marketing expenditure is included. As BT stated, these fluctuations are likely to be driven largely by the football calendar.²⁹⁴ It is therefore likely that these observed seasonal fluctuations would persist in the future.
- 6.36 At its main party hearing, BT also referred to seasonal variations resulting from new rights costs. It gave the example of the Open Golf Championship, the rights to which Sky had acquired for £15 million. BT suggested that the consequence of it acquiring such rights would be that it would fail the test as the cost of the rights exceeded its headroom under the test (about £[REDACTED] per month).²⁹⁵ We agree with Ofcom's response on this point which notes that BT's figures are not correct as the costs of such an event would be smoothed over a six-month period and the impact over those six months would be only £2.5 million (assuming no extra revenue associated with this in those months).²⁹⁶ While there may be some variation in the six-monthly smoothed average cost of rights if BT acquires the rights to individual events, as in the Open Golf example, this appeared to be a possibility rather than an actual issue. The data we have seen did not show significant seasonal variation in rights costs.
- 6.37 Marketing costs, therefore, are the main driver of any residual seasonal variation, after smoothing.
- 6.38 Ofcom has indicated that any residual variation from its approach is likely to reflect movements in competitive conditions and is consistent with the adjusted EEO approach.²⁹⁷ BT disputed this, arguing that Ofcom had not attempted to consider the full range of factors that might underpin such

²⁹³ The six-monthly smoothed costs per SFBB customer for September to December 2014 were about £[REDACTED] per customer above the annual average for 2014/15. This is based on comparing total SG&A costs per SFBB subscriber for September to December 2014 with the total SG&A costs per SFBB subscriber for April 2014 to March 2015.

²⁹⁴ BT core submission, volume 2, paragraph 165.

²⁹⁵ BT hearing transcript, p21, lines 20–26.

²⁹⁶ Ofcom hearing transcript (BT Appeal), p18, lines 13–18.

²⁹⁷ Ofcom defence (BT Appeal), paragraphs 375–376.

monthly changes; it had only focused on the possibility that they reflected a change in competitive conditions.²⁹⁸

6.39 We understand Ofcom to be making two slightly different points:

- (a) Changes in marketing costs are driven by BT's commercial decisions. If BT decided to market BT Sport more aggressively at certain points during the year, then an adjusted EEO would also have to incur higher costs to match BT's commercial strategy. It is therefore reasonable that Ofcom's smoothed cost allocation may result in a moderate increase in the net costs attributed to the periods where marketing spend is at its highest and that BT is required to maintain a higher minimum VULA margin during that period.²⁹⁹
- (b) Using longer smoothing periods risks using outdated data and ignoring genuine changes in costs. Ofcom stated that one clear trend was that, on a year-on-year basis, BT consistently spent more on rights, SG&A and programming costs in 2015 than it did in 2014.³⁰⁰ We understand Ofcom to be suggesting that the effect on competitive conditions arises not because an adjusted EEO needs to match BT's marketing spend immediately with a price cut, but due to using the wrong costs if the smoothing period is too long. We understand Ofcom to be suggesting that its six-monthly rolling average is a compromise between excessive monthly fluctuation in costs, which might occur if raw monthly numbers were used, and using numbers which are too outdated and not reflective of genuine cost changes, which might occur if costs are smoothed over a longer period.

6.40 On Ofcom's first point, we agree that an adjusted EEO would also have to incur higher costs, or discount its prices, to match BT's marketing spend. This follows from the definition of an EEO: if an EEO is equally efficient, it will provide products of similar value relative to cost.

6.41 In its response to our provisional determination, BT said that its efficient rivals will not be precisely replicating the BT Sport channels within their bundles and the value of the channels to customers will not be affected by the level of marketing spend in any compliance period or preceding months.³⁰¹ We recognise a rival will not be precisely replicating the BT Sport channels within its bundles. However, as BT noted, an efficient rival to BT will seek to supply bundles of equivalent value. In order to do so, the EEO approach assumes a

²⁹⁸ BT core submission, Volume 2, paragraph 163.

²⁹⁹ Ofcom defence (BT Appeal), paragraph 376b.

³⁰⁰ Ofcom hearing transcript, p64, lines 5–7.

³⁰¹ BT response to our provisional determination, paragraph 81(2).

rival would be expected to incur equivalent costs. The outstanding question therefore is over what period BT's marketing costs should be smoothed and then taken into account in the Margin Condition.

6.42 In taking into account BT's marketing costs and deciding over what period to smooth them, for example over six months or a longer period such as the 12-month smoothing suggested by BT,³⁰² Ofcom has balanced two aims. First, it was aiming to reduce volatility in seasonal variations in costs such that the monthly margin test was not unduly affected by month-on-month changes in costs. Second, it was seeking to ensure a consistent approach with its treatment of other costs and to reflect changes in competitive conditions to which an EEO would need to respond. As to Ofcom's second point, we accept the argument that smoothing over a longer period risks using outdated data.

6.43 We therefore determine that Ofcom has not erred in how it exercised its discretion in deciding over what period to smooth costs.

Timing differences between BT Sport costs and revenues

6.44 BT also argued that the effect of Ofcom's approach was potentially arbitrary because, where a substantial new rights cost was added, the effect would be to increase substantially the monthly costs, but there would not necessarily be an immediate or consistent correlation to increased revenues. In support of this, BT referred in particular to its acquisition of the UEFA rights.³⁰³

6.45 The acquisition of the UEFA rights is the only substantial new rights cost which BT has incurred within the Price Control period. As Ofcom submitted in its Defence, it has issued Supplementary Guidance in relation to the launch of the UEFA channels which addresses the risk that take-up of these channels might be atypically low in the period after launch. The effect of the Supplementary Guidance is to allow a time lag of 12 months between the costs of the new rights and the point at which they are taken into account in the Margin Condition. Therefore, in relation to the UEFA rights, Ofcom's approach acknowledges that there will not be an immediate and consistent correlation between new rights costs and associated revenues.

6.46 Insofar as BT referred more generally to the guidance in the Final Statement on material changes in circumstances (which contemplates a significant change in BT's business model that may lead to atypically low volumes),³⁰⁴

³⁰² BT core submission, volume 1, footnote 9.

³⁰³ BT AmNoA, paragraphs 198 & 199(2).

³⁰⁴ [Final Statement](#), paragraphs 6.22–6.26.

Ofcom has explained that it will respond flexibly to such material changes as appropriate.

- 6.47 In its Core Submission Volume 2, BT submitted, however, that the issuing of *ad hoc* supplementary guidance, which was dependent on a prior finding that a change is sufficiently 'material' to justify a departure from the approach in the Final Statement, did not address the underlying design defect in the test. This, BT alleged, gave rise to the 'clear risk' of BT failing the monthly bright-line test in circumstances which may not suggest any risk of harm to consumers.³⁰⁵
- 6.48 We do not find this argument to be persuasive. Ofcom's approach to BT's acquisition of UEFA rights shows that it is prepared to take a more flexible approach in its application of the Margin Condition in response to a material change in circumstances. We consider these arguments in more detail in the context of BT's alleged errors in paragraphs 7.95 to 7.132 on legal certainty. In the context of reference question 3(f), we consider that Ofcom has not erred in the way it has taken into account time lags between costs and revenues.
- 6.49 In its response to our provisional determination, BT said that significant new rights may be introduced into existing channels to maintain or to enhance their value without any immediate change in BT's commercial approach.³⁰⁶ It went on to argue that 'Ofcom's standard static approach to the net cost of BT Sport would allow for no account to be taken of changes in the long term value of the channels but would take immediate account of increased costs'. We consider that this point repeats BT's pleadings on the static approach which we assess in Section 5.

Long term trend in BT Sport costs and revenues and changes in the bases of SFBB/SBB customers

- 6.50 BT also stated that the effect of Ofcom's approach was potentially arbitrary because Ofcom had ignored what BT said was a general downward trend in the net costs of BT Sport per SFBB subscriber. In this context, BT referred to increasing direct revenues, the increasing base of BT SFBB customers and the mix of subscribers moving from SBB to SFBB.³⁰⁷

³⁰⁵ BT core submission, volume 2, paragraph 171.

³⁰⁶ BT response to our provisional determination, paragraph 82.

³⁰⁷ BT AmNoA paragraphs 198, 199(3) & 199(4).

6.51 The evidence BT relied on is set out in Figure 8 below. This sets out the net costs of BT Sport in line with Ofcom's calculation method.

Figure 8: Net costs of BT Sport per SFBB customer

[✂]

Source: First witness statement of James Tickel (BT Appeal), paragraph 67.

6.52 In its Defence, Ofcom stated that the above evidence did not support BT's assertion that there was a general downward trend in the net costs of BT Sport per SFBB subscriber. Ofcom made the following points:

- (a) Figure 8 failed to demonstrate a clear downward trend in the monthly net costs per SFBB subscriber. Rather, the monthly net costs per SFBB subscriber [✂].
- (b) BT's data for January to August 2014 was not reliable as it was affected by adjustments BT had made to exclude launch costs which, under Ofcom's method, are separately recovered over five years.³⁰⁸ BT's estimates for September 2014 to March 2015 were also likely to be distorted by an accounting adjustment to SG&A costs that was likely to have a lesser impact overall.
- (c) BT's data went up to March 2015, but data for April 2015 showed [✂] from March 2015.³⁰⁹
- (d) Trends in historical data may provide little information about the likely future trends in the net cost of BT Sport per SFBB subscriber. Ofcom referred to BT's UEFA content resulting in substantial changes in both costs and revenues from August 2015 and to the increased cost of FAPL rights from August 2016.³¹⁰

6.53 In responding to Ofcom's points about its adjustments to launch costs and the accounting adjustment to SG&A costs, BT stated that these points did not affect its argument about the downward trend of net cost per SFBB customer, as its approach to these issues was conservative.³¹¹

³⁰⁸ Ofcom considered launch costs were incurred over August 2013 to March 2014, but under Ofcom's approach six-month smoothing means figures up to August 2014 are affected.

³⁰⁹ Ofcom defence (BT Appeal), paragraph 383.

³¹⁰ Ofcom defence (BT Appeal), paragraph 384.

³¹¹ BT core submission, volume 2, paragraphs 177 & 178.

6.54 We next consider what the historical data shows and what can be inferred from the data about the general trend in the net cost per SFBB customer of BT Sport.³¹²

6.55 We took account of the data issues Ofcom identified (see paragraph 6.52(b) above) and to the seasonal variation in marketing costs. There are two effective approaches that can be taken:

(a) The first approach involves excluding SG&A costs and considering unsmoothed monthly data. Excluding SG&A costs removes most of the seasonality and substantially deals with the data issues. Considering unsmoothed data means the monthly data is more granular and simpler to interpret. The disadvantage of this approach is that no account is taken of SG&A costs. See Figure 9.³¹³

Figure 9: Net cost of BT Sport (£ per SFBB customer*)

[✂]

Source: Ofcom defence (BT Appeal) (Volume 4, tabs 39 and 41).

* Calculation uses average customer numbers for the six-month rolling period.

Note: The April 2015 figure does not include Ofcom's adjustments. This is for consistency with BT's figures for April 2014 to March 2015.

(b) The second approach involves calculating the average net costs per SFBB customer over a full 12-month period.³¹⁴ This addresses seasonality and substantially addresses the data issues which concern the distribution of costs between months. The disadvantage of this approach is that the number of observations is reduced to ten and these are not independent of each other. See Figure 10.³¹⁵

Figure 10: Net cost of BT Sport (£ per SFBB customer, 12-month averages)

[✂]

Source: Ofcom defence (BT Appeal) (Volume 4, tabs 39 and 41).

Note: The April 2015 figure does not include Ofcom's adjustments. This is for consistency with BT's figures for April 2014 to March 2015.

6.56 As can be seen from the above, Figure 9 shows a decline in the net cost of BT Sport between August 2013 and April 2015. This decline was greatest at

³¹² In considering the historical data, BT did not give any reason for disregarding the [✂] in cost per SFBB customer in April 2015 so we have included this in our consideration.

³¹³ In relation to the data issues Ofcom identified (see paragraph 6.52(b) above), the launch cost issue mainly affects SG&A costs, which are excluded from Figure 9, but does also affect programming costs. We considered two different approaches to the exclusion of programming launch costs from programming costs for August 2013 to March 2014. The first uses BT's assumption that programming launch costs are distributed equally between months and the second instead assumes launch costs represent a constant percentage of programming costs. However, there was very little difference between the results using these two approaches. Figure 9 is based on the first approach.

³¹⁴ This differs from Ofcom's smoothing not only because averages are taken over 12, rather than six, months but because cost, revenue and subscriber numbers are averaged over the 12-month period.

³¹⁵ Figure 10 shows SG&A costs separately as they are excluded from Figure 9.

the start of the period. [REDACTED]. Figure 10 shows a similar picture and the context for [REDACTED].

- 6.57 Further, we cannot extrapolate from the historical data any meaningful trend in the net cost of BT Sport which may be expected to continue into the Price Control period. This is for three reasons:
- (a) The data covers a short period of only 22 months from which it is difficult to infer a general trend.
 - (b) BT acquired its FAPL rights at the beginning of this period and net costs during the first part of the period are therefore likely to reflect a timing difference between costs and revenues. As discussed above in relation to UEFA rights, Ofcom accepted a timing difference of 12 months (see paragraph 6.45) given the risk that take-up of these channels might be atypically low in that period. It is only during the first 12 months that the decline in net cost is clear (see Figure 9).
 - (c) During the period covered by the graph, increases in the amount BT paid for rights were limited. The main increase after September 2013 was due to the acquisition of European rugby rights for £[REDACTED] per month in August 2014, and the total increase in monthly payments between September 2013 and April 2015 was £[REDACTED]. By contrast, the increase in BT's payment for FAPL rights in August 2016 is £[REDACTED] per month.³¹⁶ There was some increase due to the acquisition of new rights, but the cost of individual rights remained broadly stable. However, both BT and Ofcom referred to a general trend of increasing rights costs,³¹⁷ and we noted that in August 2016 the cost of BT's FAPL rights will increase by 30% (representing 18% per game).³¹⁸
- 6.58 BT also referred at its main party hearing to its increasing revenue from BT Sport. It said that BT Sport was a relatively new business: the revenues on day one were [REDACTED], and the revenues for the current financial year were about £[REDACTED].³¹⁹ We note this includes revenue from BT customers for the UEFA channels (2015/16) and compares to annualised revenue for April 2015 of £[REDACTED], an increase of £[REDACTED]. However, increases in rights costs would have been greater over this period since UEFA costs from August 2015 would be about £[REDACTED] for the remaining eight months of 2015/16.³²⁰

³¹⁶ These are smoothed, six-month average figures.

³¹⁷ Witness statement of John Petter, paragraph 93.

³¹⁸ Ofcom defence (BT Appeal), Volume 4 Tab 41; Witness statement of John Petter, paragraph 61.

³¹⁹ BT hearing transcript, p22, lines 7–8.

³²⁰ Ofcom defence (BT Appeal) Volume 4, Tab 41.

- 6.59 The increases in direct revenues to which BT referred, together with the significant increases in rights costs, illustrate that the financials of BT Sport are developing, reflecting that it is a relatively new business. However, there is no clear trend in the net costs, as BT is continuing to invest in new content in order to support revenue growth.
- 6.60 As BT argued, the net cost per SFBB customer is also affected by the percentage of BT Sport customers with SFBB and the number of SFBB customers. However, we were not provided with projections of these numbers; and, on the basis of trends up to April 2015, we are not persuaded that changes in them would be sufficient to cause a trend decrease in net cost per SFBB customer.
- 6.61 Our analysis of the data made available to us in this appeal, and summarised above, does not, in our view, show a meaningful trend in the net sports costs per SFBB customer which might be expected to continue into the Price Control period.
- 6.62 In its response to our provisional determination, BT said that its evidence in relation to long term trends:³²¹
- simply showed that Ofcom’s net cost calculation in any compliance period (and the resulting margin requirement) was defective in failing to take any account of the realistic possibility (reflected in the historic evidence) that net costs might change in future months.
- 6.63 As we conclude in paragraph 6.61, we do not agree that the evidence showed a meaningful trend in net costs per subscriber which might be expected to continue into the price control period. To the extent that there is a ‘realistic possibility’ that net costs might change in future months, this simply, in our view, reiterates BT’s arguments about the static approach which we address in Section 5.³²²
- 6.64 We determine therefore that Ofcom did not err in its consideration of the evidence available to it on long-term trends.

³²¹ BT response to our provisional determination, paragraph 83.

³²² BT response to our provisional determination, paragraph 83.

Nature of competition in content markets and the perverse effects of the Margin Condition in relation to BT Sport

- 6.65 In the third limb of reference question 3(f), BT alleged that Ofcom failed to take into account the nature of competition in content markets and how this affected competition in SBB and/or SFBB, in particular between BT and Sky.
- 6.66 In its Amended Notice of Appeal, BT said that the flaws it had identified in the Margin Condition were accentuated by the absence of what BT would regard as a proper assessment of the nature of competition in content markets and how this affected competition in SBB and/or SFBB, in particular between BT and Sky.³²³ BT referred to the advantages held by other CPs (Sky, Virgin Media and TalkTalk) and to an alleged regulatory asymmetry whereby BT had to supply wholesale broadband to Sky but Sky did not have to supply its Pay TV content to BT.
- 6.67 Ofcom said it recognised that an inevitable consequence of this type of regulation was that, in some circumstances, it may constrain BT's behaviour; and that it was possible that the Margin Condition would affect BT Consumer's commercial behaviour in relation to Pay TV services, where it bundled those services with SFBB. Ofcom said it explained at paragraphs 7.58 to 7.67 of its Final Statement why it considered that the Margin Condition would not adversely affect BT in Pay TV in a manner that was disproportionate to Ofcom's overall regulatory aim. Ofcom added that, to the extent BT meant to argue that it should be able to use its SMP in the WLA market to mitigate any disadvantages in the provision of premium sports content vis-à-vis Sky, it was inappropriate to allow BT to set an insufficient VULA margin in order to compensate for the 'disadvantages' it may face in Pay TV. This was because there was a 'clear and real risk that BT would use this flexibility to distort competition in the retail provision of SFBB bundles'.³²⁴
- 6.68 BT said this failed to address its case that, as a new entrant in the provision of premium sports content, it was incurring heavy fixed investment costs that could not be recovered in the short term.³²⁵ We address BT's points about the costs of entry under reference question 3(g) (below).
- 6.69 In our view, Ofcom did consider the effects of the Margin Condition on BT's ability to compete in Pay TV; finding that such effects would be relatively limited and that, given the importance Ofcom attached to preventing a

³²³ BT AmNoA, paragraph 203; Witness statement of John Petter, paragraphs 30–45 and 70–71; and witness statement of Stuart Murray, paragraphs 72–79.

³²⁴ Ofcom defence (BT Appeal), paragraphs 441 & 442.

³²⁵ Core submission hearing transcript (BT Appeal), volume 2, paragraph 209.

distortion in SFBB, the impact on BT in Pay TV did not give rise to adverse effects disproportionate to Ofcom's regulatory aim.

6.70 In its Amended Notice of Appeal,³²⁶ BT also alleged that the design of this aspect of the Margin Condition placed 'disproportionate restrictions on BT's freedom to develop retail propositions incorporating its BT Sport channels and to set fair and competitive prices'. In its pleadings, BT referred to various alleged 'perverse effects' of the Margin Condition in support of its arguments.³²⁷

6.71 Responding to BT's points about the alleged perverse effects of the Margin Condition, Ofcom made the following points in its Defence:³²⁸

- (a) The risk of 'cream skimming' arose from BT's commercial decision to charge the same price for a SFBB bundle regardless of whether consumers subscribed to BT Sport, rather than as a result of the Margin Condition.
- (b) The constraints imposed by the Margin Condition were proportionate and necessary to ensure competition in SFBB is not distorted.
- (c) The Margin Condition may in certain circumstances amplify the consequences for BT of its good and bad investments, relative to a scenario where BT chose not to make that investment. In particular, if BT were to make a bad commercial decision, eg if the value that an investment generates turns out to be below the costs of such investment, BT could not disregard the costs of that investment and might instead have to adjust its VULA wholesale price or its retail pricing to ensure its compliance with the Margin Condition. However, the reverse was also true. If BT were to make a good commercial decision, in addition to the increased profits BT could expect as a result of that decision, it could effectively use some of those profits to set a lower VULA margin. Ofcom also said it was unclear what alternative approach was available. It said that one alternative would be to use the expected, rather than the actual, costs and revenues, but in practice it would be challenging to estimate the costs and revenues from an uncertain investment accurately. Ofcom also said that evidence to date did not suggest that BT was being dissuaded from investing in sport.

³²⁶ BT AmNoA, paragraph 201.

³²⁷ Witness statement of John Petter, paragraphs 89-100; RBB report, Section 5.

³²⁸ Ofcom defence (BT Appeal), paragraphs 388-398.

- 6.72 In relation to BT's arguments on potential 'cream-skimming'³²⁹, we agree with Ofcom that this arises due to BT's decision to bundle BT Sport channels with SFBB. BT's claim that the Margin Condition increases the opportunity for cream skimming appears to rely on the assumption that the value to consumers of the BT Sport channels is less than the net cost.³³⁰ We were not persuaded on the evidence before us that this is the case.
- 6.73 In relation to the other points, Ofcom accepted that the Margin Condition may amplify the consequences for BT of its good and bad investments. Such effects could be described as perverse; for example if, as suggested by Ofcom,³³¹ greater than expected pay-offs on a sports investment by BT enables it to increase its wholesale VULA prices to its rivals. Moreover, even if the Margin Condition in theory only amplifies the consequences of good and bad investments, it is still possible that, in practice, it reduces BT's incentive to invest compared to the situation where there is no Margin Condition. This may be the case, for example because BT is risk-averse or because BT perceives an obstacle to increasing its VULA price to take advantage of successful investment.³³²
- 6.74 However, as we set out in paragraph 6.67 above, Ofcom stated in its Defence that it is inevitable that a margin control imposes some constraint on BT.³³³ As discussed further below in paragraphs 6.116 to 6.120, BT has continued to comply with the Margin Condition and to invest in BT Sport. In relation to the perverse effects suggested, we have not seen evidence that they have in practice occurred, or are likely to occur in future. Overall, we are not persuaded that BT has demonstrated that the constraints the Margin Condition has imposed on BT are disproportionate to Ofcom's aim in imposing the Margin Condition.
- 6.75 In its response to our provisional determination, BT said it was possible that our provisional determination was based, in part, on a belief that, even if it is in reality likely to constrain BT's ability to compete effectively in the supply of SFBB bundles incorporating premium sports content, the current approach was unlikely to cause significant consumer harm within the remaining period until the next market review.³³⁴

³²⁹ See paragraph 6.16(a).

³³⁰ BT core submission, volume 2, paragraph 189.

³³¹ Ofcom hearing transcript (BT Appeal), p67, lines 7–8.

³³² If BT is risk averse, it will attach more weight to adverse than beneficial consequences and amplification of effects will discourage it from undertaking investment. If BT perceives an obstacle to increasing its VULA price to take advantage of successful investment, the benefits of successful investment are reduced and there is no longer symmetry between adverse and beneficial effects.

³³³ Ofcom defence (BT Appeal), paragraph 441.

³³⁴ BT response to our provisional determination, paragraph 73.

- 6.76 Our provisional determination was based on an assessment of all relevant factors and our overall findings on BT's reference questions. It was not based on the fact that there is a short remaining period until the next market review. However, our determination cannot be regarded as identifying a level of margin that must be made available beyond March 2017 to BT's rivals to ensure they can compete profitably. This is because both the future need for margin control and the method to be applied will depend on the circumstances at the time, including the risk of BT imposing a price squeeze and, in relation to BT Sport, the extent to which it is bundled with SFBB.
- 6.77 BT also said that while its challenge in this appeal related to the treatment of BT Sport within the *ex ante* remedy, its underlying concerns remained the same as during the Consultation phase.³³⁵ It had argued in response to the Consultation that BT Sport should be excluded from an *ex ante* margin assessment – to ensure that the restrictions placed on BT's commercial activity were not simply driven by a point in time measure of net costs, but reflected concerns with the ability of BT's rivals to compete profitably and effectively.
- 6.78 BT argued in its response to our provisional determination that consideration should be given to 'the effect that BT's bundling has on consumer purchasing decisions for SFBB (and SBB) services and on the ability of BT's rivals to offer effective competition to BT's offers on a profitable basis'.³³⁶ BT stated that 'the ability of BT's rivals – notably Sky – to provide access to alternative sports content within their own bundles is clearly relevant in considering the impact any bundling may have on the retail supply of broadband'. BT argued that the Final Statement made no such assessment of this. BT's response to our provisional determination made the following additional points:
- (a) BT said that 'Ofcom should have directly considered the extent to which Sky's market position might impact BT's ability to use the provision of sports content it had acquired to distort competition in the supply of SFBB services (by bundling such content as part of its overall SFBB offering) such that consumers suffered harm in the long run due to a reduction in the competitiveness in the supply of broadband services'.³³⁷
 - (b) BT said that, in addressing this, both the impact of BT's ability to compete in Pay TV and the impact of BT's investments in BT Sport on its rivals to compete in SBB and SFBB are relevant, but the primary issue was 'the

³³⁵ BT response to our provisional determination, paragraph 77

³³⁶ BT response to our provisional determination, paragraph 84.

³³⁷ BT response to our provisional determination, paragraph 85

impact on broadband competition as the market defined by Ofcom'. BT said that we had focused 'on the impact on BT's ability to compete in pay-tv rather than the impact of BT's investments in BT Sport on BT's rivals to compete in DBB and SFBB'.³³⁸

- (c) BT said that our conclusion in our provisional determination was not an adequate assessment of BT's appeal on this issue or of the proportionality of the constraints placed on BT's ability to supply BT Sport within bundles.

6.79 In response to these points, we consider it relevant that having found a relevant risk of price distortion due to BT's ability to impose a price squeeze, Ofcom decided that the appropriate conceptual approach to controlling BT's margin was an adjusted EEO. In light of this, Ofcom correctly based the design of the control on an adjusted EEO, not on Sky and its market position in Pay TV. BT did not challenge the adjusted EEO approach except in regard to the adjustment for ACL. We have assessed fully, in paragraphs 6.65 to 6.76, BT's arguments in its pleadings on the third limb of reference question 3(f). Further, we assess BT's arguments that its position in the market for Pay TV affected its BT Sport costs in our assessment of reference question 3(g). We therefore consider that we have adequately assessed BT's appeal on these issues.

6.80 For the reasons set out in paragraphs 6.65 to 6.79, and taking into account our assessment of BT's arguments about the size of the costs and revenues of BT Sport and long-term trends and seasonality, we determine that BT has not demonstrated that Ofcom erred in relation to the third limb of reference question 3(f) on the nature of competition in content markets.

Our determination on reference question 3(f): Treatment of BT Sport costs

6.81 For the reasons set out in paragraphs 6.22 to 6.80 above, we determine that Ofcom did not err in its treatment of BT Sport costs in the way alleged by BT in reference question 3(f).

Reference question 3(g): Costs of entry

BT's case

6.82 In its Amended Notice of Appeal, BT stated that Ofcom was wrong in having rejected its argument during the Consultation that Ofcom's model failed to make proper allowance for BT's long-term costs of entry into the provision of

³³⁸ BT response to the provisional determination, paragraph 86

sports content. BT considered that the effect of Ofcom's approach was that BT was required, on a monthly basis, to allocate the costs of sports content that it had been unable to recover elsewhere so that its new SFBB customers met such costs on a 'per customer' basis.³³⁹

- 6.83 BT submitted that this obligation represented a fundamental error of analysis in that the costs of BT's entry into the sports rights sector had nothing to do with the ability of other CPs to compete against BT in the supply of SFBB bundles. BT considered that the effect of Ofcom's approach was to eliminate the indirect value to BT of monetising BT's sports rights as part of BT's bundled retail products, ie Ofcom's approach removed the benefits to BT of including its sports content in bundles (eg the opportunity to cross-sell other BT services) while including all of the costs of bundled products and services.³⁴⁰
- 6.84 BT stated that it was incurring substantial costs of entry into the provision of sports content, and this was a function of its need to compete against Sky, which BT considered was a very powerful and well-entrenched supplier at both the wholesale and retail levels with a much larger retail base of Pay TV customers. BT submitted that, if it was unable to recover all of its monthly sports costs from (i) direct revenues in that month, and (ii) the cohort of new subscribers acquired in that month, this had no bearing on conditions of competition in the retail broadband market.³⁴¹
- 6.85 BT submitted that there was therefore no proper basis for including, in the Margin Condition, any losses incurred by BT in seeking to compete in the provision of sports content. BT also submitted that requiring it to 'recover from new customers in every month 'losses' that it was unable to recover in that month in this way provided an unjustified "price umbrella" to SFBB competitors (including Sky itself) which was unrelated to any impact of sport in the broadband market'.³⁴²
- 6.86 BT further submitted that Ofcom's treatment of BT Sport costs in the Margin Condition also increased the risks which BT faced in entering the markets for the supply of sports content. BT said these markets were highly concentrated, and Ofcom had, in effect, created a significant regulatory barrier to entry to BT in upstream and downstream markets. BT highlighted that these had been

³³⁹ BT AmNoA, paragraphs 204 & 205.

³⁴⁰ BT AmNoA, paragraph 206.

³⁴¹ BT AmNoA, paragraph 207.

³⁴² BT AmNoA, paragraph 208.

identified by Ofcom for many years as suffering from a lack of effective competition.³⁴³

Our assessment of reference question 3(g): Costs of entry

6.87 In assessing this reference question, we first consider what we understand BT to be referring to in its use of the term ‘costs of entry’ and what errors it is alleging. We then consider the arguments made out in paragraphs 204 to 209 of BT’s Amended Notice of Appeal. These concern:

- (a) alleged errors by Ofcom in rejecting BT’s arguments during the Consultation;
- (b) Ofcom’s approach to indirect monetisation; and
- (c) taking account of costs of entry as a function of competing against Sky.

Meaning of costs of entry

6.88 Ofcom’s stated in its Defence that “there is some ambiguity as to what BT means when it refers to the “costs of entry into the provision of sport content””.³⁴⁴ We agree and set out what we understand BT’s argument to be.

6.89 In doing so, we consider it helpful to refer first to the arguments made during the Consultation. In the Final Statement, Ofcom addressed two high-level considerations relevant to how it calculated the net costs of BT Sport:

- (a) Whether BT incurs overall losses from its BT Sport investment including specifically, as BT proposed during the Consultation, whether Ofcom should deduct £[~~3~~]³⁴⁵ from the costs of BT Sport to reflect losses associated with BT’s FAPL rights.
- (b) Whether the timing of cost recovery should be adjusted to reflect increasing profitability of BT Sport over time.³⁴⁶

6.90 BT made a number of arguments during the Consultation and, in support of those arguments, provided Ofcom with documentary evidence. None of these documents has been submitted by BT to us as evidence in this appeal. We thus conclude that BT does not rely in its appeal on the internal BT

³⁴³ BT AmNoA, paragraph 209.

³⁴⁴ Ofcom defence (BT Appeal), paragraph 403.

³⁴⁵ [Final Statement](#), paragraph 6.281.

³⁴⁶ [Final Statement](#), paragraph 6.278.

documents which were provided to, and considered by, Ofcom when it came to its decision in the Final Statement in relation to costs of entry.³⁴⁷

6.91 Further, BT has not sought, in this appeal, to challenge Ofcom's assessment of the rationale for BT's investment in BT Sport, as set out in Annex 1 to the Final Statement. Nor has BT challenged Ofcom's rejection of BT's proposal during the Consultation that £[redacted] million should be written off.

6.92 We sought clarification from BT at its main party hearing about what it was relying on in relation to this part of the appeal. BT indicated that it was not arguing, as part of its appeal, that there are 'identifiable costs that can be written off' but that the 'reality of [BT's] position in the market is that there will be costs of entry'.³⁴⁸

6.93 We therefore consider that in referring to costs of entry in the provision of sport content, BT is arguing that there are costs of entry which should be deferred. At its main party hearing, BT said that it faced significant barriers of entry to get into sport in the first place because Sky, as the incumbent, had major bidding advantages for sports rights.³⁴⁹ BT explained:

[...] we saw that there was a strategic and strong imperative for us to get into sport and to strengthen our competitive position and to bring competition to that marketplace. But there are huge obstacles to getting into that market, [redacted].³⁵⁰

6.94 We understand from this that BT's 'long term costs of entry' amount to the start-up losses it has incurred during the early years of its involvement in the sports content market and which it expects to recover over the long term as the profitability of its sports content increases. BT started to supply sports content in August 2013, at the start of the 2013/14 football season when it first had the rights to some FAPL matches. Subsequently, BT has acquired other sports rights including, from August 2015, the UK rights to all televised UEFA Champions League and Europa Cup matches (UEFA rights). We therefore understand BT's argument to be that it would continue to incur start-up losses during the period of the Margin Condition (April 2015 to March 2017).

6.95 Having determined that BT is referring to what we call start-up losses in its references to costs of entry, we next turn to what Ofcom said in its Final

³⁴⁷ [Final Statement](#), paragraphs 6.268–6.314 (as relied on by BT in BT AmNoA, paragraph 204).

³⁴⁸ BT hearing transcript, p88, lines 3–4.

³⁴⁹ BT hearing transcript, p66, lines 12–14.

³⁵⁰ BT hearing transcript, p67, lines 1–6.

Statement and BT's assertion that Ofcom was wrong to reject BT's arguments in the Consultation.

Ofcom's rejection of BT's arguments in the consultation process

- 6.96 Beyond spreading initial launch costs over five years, Ofcom did not make any allowance for start-up losses during the Price Control period. In its Final Statement, Ofcom accepted (as do we) that, as a matter of principle, 'where a new business expects its profitability to increase in the future, it may be appropriate to defer the recovery of some costs'.³⁵¹ Ofcom went on to set out the circumstances in which it considered whether a deferral of the recovery of some costs would be appropriate in relation to BT Sport when assessing the VULA margin. In doing so, Ofcom focused on the circumstances in which BT launched and currently distributes BT Sport:

As set out in Annex 1 to the Final Statement, BT has developed BT Sport largely to support its broadband business. It has chosen to provide access to BT Sport to its broadband customers free of charge. Given BT's approach to distribution, economies of scale in Pay TV channels are less important than would be the case for a stand-alone new entrant channel. BT already has a large and well-established customer base over which it is able to spread the cost of BT Sport from day one. Indeed, with [redacted] million customers BT is currently the largest retail provider of broadband in the UK.

Separately, we recognise that BT earns revenue from other sources. Our indicative assessment shows that direct revenues such as wholesale payments from Virgin and Setanta, payments from BT Sport subscribers on the Sky satellite TV platform and payments from pubs and clubs account for [redacted]% of the costs of BT Sport. BT launched its TV service (BT Vision) in 2006. Its current BT Sport product was launched in 2013 and therefore BT has already had the opportunity to build the scale of its current sports business. We also note that the growth in the direct revenues associated with the current tranche of the FAPL rights may be [redacted].

³⁵¹ [Final Statement](#), paragraph 6.292.

Given current circumstances, we thus do not consider that it is appropriate to adjust the profile of cost recovery to reflect future costs and revenues.³⁵²

- 6.97 In considering these points, it is relevant that BT did not provide an alternative explanation for the documents set out in Annex 1 to Ofcom's Final Statement and on which Ofcom based its assessment that BT had developed BT Sport largely to support its broadband business. We therefore conclude that BT has not sought to challenge that analysis in this appeal.³⁵³
- 6.98 Further, as Ofcom observed, BT acquired FAPL rights from August 2013. Given that the Margin Condition was imposed from April 2015, there were approximately 20 months between the acquisition of the rights and the point at which they became relevant in the Margin Condition. BT's position is that any start-up losses continued beyond April 2015. However, BT has provided no evidence to suggest over what period start-up losses would continue to be incurred and therefore over what period a deferral of costs might be appropriate.
- 6.99 At its main party hearing, we put it to BT that it had not provided evidence which identified its claimed entry costs. BT responded that the focus has to be on the effects that the provision of this content by BT has on the ability of competitors to compete.³⁵⁴ We nevertheless consider that BT's evidence in support of its claimed entry costs is relevant to our assessment. As discussed in paragraph 6.27 above, the inclusion of BT Sport channels in BT's SFBB bundles is relevant to the Margin Condition and, if BT cannot show that it is incurring start-up losses, it has not demonstrated an error in Ofcom's calculation of the net cost of BT Sport.
- 6.100 Ofcom clearly considered, in its Final Statement, the evidence BT submitted to it on costs of entry during the Consultation. Ofcom concluded that this evidence was [redacted].³⁵⁵ In its Core Submission Volume 2, BT stated 'Ofcom did not engage in any detailed consideration of BT's business projections or take account of directional movement over time in claiming there was no evidence to support the claim that the profitability of BT Sport would improve over time'.³⁵⁶ In our view, BT has not shown what Ofcom should have considered, or in what particular way it did not engage. It has not relied in this appeal on

³⁵² [Final Statement](#), paragraphs 6.292 & 6.292A.

³⁵³ BT said that Ofcom had misunderstood its decision to invest in sport but did not explain further beyond stating that its investment in sport was part of a battle with Sky in relation to access to Pay TV content. Witness statement of John Petter, paragraph 48.

³⁵⁴ BT hearing transcript, p78, lines 5–7.

³⁵⁵ [Final Statement](#), paragraph 6.301.

³⁵⁶ BT core submission, volume 2, paragraph 56.

the evidence which it provided to Ofcom during the Consultation and has not specified in what ways Ofcom erred in its consideration of that evidence.

6.101 We therefore determine that Ofcom did not err, as alleged, in rejecting BT's argument in the Consultation that Ofcom's model failed to make proper allowance for BT's long-term costs of entry into the provision of sports content.

Indirect monetisation

6.102 BT argued that Ofcom further erred in that its approach eliminated the indirect value to BT of monetising BT's sports rights as part of BT's bundled retail offer.³⁵⁷ Ofcom disputed this, arguing that the Margin Condition does take into account the effects of a larger base of customers and any higher prices that BT can charge due to including BT Sport in its SFBB bundles.³⁵⁸ In its Core Submission Volume 2, BT partially accepted this point, at least in regard to higher prices. However, at its main party hearing and in its Core Submission Volume 2, BT continued to argue that elements of indirect monetisation were excluded, specifically that Ofcom's calculation of net cost per SFBB customer:

- (a) would not include indirect monetisation from acquired SBB customers;³⁵⁹
- (b) would also not include indirect monetisation from reduced churn and extended ACL; and
- (c) represented a static approach that failed to take into account indirect monetisation from future growth³⁶⁰ and upselling.³⁶¹

6.103 Indirect monetisation is the incremental revenue (less costs) that BT obtains from bundling BT Sport channels with BT broadband. Such additional revenue comes from acquiring or retaining additional customers as a result of bundling BT Sport channels with BT broadband, or from being able to charge a higher price for broadband than if BT Sport channels were not included in the bundles. In any period (eg month or year), indirect monetisation affects economic profits/losses as follows:

$$\begin{aligned} & \text{COSTS} - \text{DIRECT REVENUE} - \text{INDIRECT MONETISATION} \\ & = \text{ECONOMIC LOSSES/PROFITS} \end{aligned}$$

³⁵⁷ BT AmNoA, paragraph 206.

³⁵⁸ Ofcom defence (BT Appeal), paragraph 446.

³⁵⁹ BT core submission, volume 2, paragraph 210(3).

³⁶⁰ BT core submission, volume 2, paragraph 210(1).

³⁶¹ BT hearing transcript, p82, lines 4–7.

- 6.104 That is, if costs are greater than the total of direct revenue and indirect monetisation, BT will incur economic losses.³⁶² These should be distinguished from accounting losses which would be calculated simply from the difference between costs and direct revenue.³⁶³
- 6.105 It is common ground between Ofcom and BT that relevant economic losses should be calculated after taking account of both direct revenue from the BT Sport channels and indirect monetisation.³⁶⁴
- 6.106 We now turn to BT's specific points on indirect monetisation (see paragraph 6.102 above). On the first point, we consider it relevant that although the bundling of BT Sport may lead to additional SBB as well as SFBB customers, additional SBB customers do not directly affect the margin on new SFBB customers. It is the margin on new SFBB customers which is relevant under Ofcom's cohort approach. Furthermore, additional SBB customers indirectly increase BT's margin on new SFBB customers because of the allocation of net sports costs between SBB and SFBB customers. For example, other things equal, the greater the number of SBB customers taking BT Sport, the smaller the proportion of net BT Sport costs which are allocated to SFBB customers and included in the calculated margin.³⁶⁵ We therefore consider that additional SBB customers do have an indirect effect on BT's margin.
- 6.107 BT's other points on indirect monetisation (see paragraphs 6.102(b) and (c)) relate to the potential for the bundling of BT Sport to increase expected ACL and the argument that its margin will increase over time due to future growth and upselling. We assessed BT's arguments that the ACL should be higher and should not be fixed in Section 4 above and concluded that Ofcom had not erred. Similarly, we considered BT's arguments on Ofcom's static approach in Section 5 above and again found Ofcom has not erred.
- 6.108 In its response to our provisional determination, BT stated that it did not consider we had fully assessed the arguments put forward in BT's evidence on 'costs of entry'. BT said we appeared to assume that the value of indirect monetisation (measured on a per customer per month basis) was equal to the net cost of BT Sport plus any margin headroom; that we were therefore of the

³⁶² If BT incurs economic losses in a period, this may be for a number of reasons, including: start-up losses; time lags arising from slower build-up of revenue than costs when major new rights are acquired; and, if the period is shorter than a year, greater seasonality of costs than revenue. In this section, we are concerned with start-up losses; we consider seasonality and time lags in paragraphs 6.32–6.43 and 6.44–6.49 respectively.

³⁶³ Ofcom used the phrase 'unrecovered monthly losses' and BT the phrase 'unrecovered losses' to refer to economic losses.

³⁶⁴ Ofcom defence paragraphs 405–407 and BT core submission, volume 2, paragraph 195.

³⁶⁵ An increase in SBB customers also enables BT to spread its non-BT Sport fixed costs over a greater number of customers.

view that it was making no economic losses on the BT Sport channels; and that this produced an essentially circular logic to reject its challenge in relation to the costs of entry and Ofcom's approach.³⁶⁶

6.109 We considered BT's specific points about indirect monetisation in paragraphs 6.106 and 6.107. We concluded that Ofcom's approach did take into account potential additional SBB customers and noted the relevance of our separate conclusions that Ofcom did not err in relation to ACL or the static approach. We have considered BT's points about potential economic losses (start-up losses) in our overall assessment of reference question 3(g). In doing so, we did not make assumptions about the exact value of any indirect monetisation nor potential economic losses (start-up losses) on the BT Sport channels. We therefore do not agree that our assessment applied circular logic to address BT's points.³⁶⁷

6.110 BT also stated in its response to our provisional determination that the value of its indirect monetisation benefits can only be assessed 'by reference to the margin that BT makes across **all** broadband customers receiving access to the BT Sport channels compared to the margin BT would make across all broadband customers in the counter-factual position where BT did **not** supply access to the BT Sport channels to its customers'. [original emphasis]

6.111 If BT is implying that this suggests an error in Ofcom's approach, we disagree. It is the margin on new SFBB customers, not on all broadband customers, which is relevant under Ofcom's cohort approach.³⁶⁸

6.112 We conclude that BT has not demonstrated that Ofcom's approach eliminates the indirect value to BT of monetising BT's sports rights as part of BT's bundled retail offer.

Costs of entry as a function of competing against Sky

6.113 BT argued that it was incurring costs of entry in the provision of sports content as a function of needing to acquire rights in competition to an established player, Sky, which is able to value content in any rights auction at a much higher level, given its ability to retail the acquired content to an established and sizeable base of paying customers.³⁶⁹ It further argued that there was no

³⁶⁶ BT response to our provisional determination, paragraph 92.

³⁶⁷ BT response to our provisional determination, paragraph 93. This describes economic losses as 'potential costs of entry/start-up losses'.

³⁶⁸ See paragraph 6.106.

³⁶⁹ BT core submission, volume 2, paragraph 207; and BT response to our provisional determination, paragraph 94.

basis for including any losses incurred by BT in competing in the provision of sports content in the Margin Condition.³⁷⁰ It again cited its arguments that the Margin Condition provided an unjustified 'price umbrella' and the case put forward in Section 5 of the RBB report and Sky's advantage deriving from its position in Pay TV.

6.114 We do not consider that any ability of Sky to retail acquired content to an established and sizeable base of paying customers in itself provides evidence of BT having incurred entry costs in the form of start-up losses. Ofcom noted that BT had a 'large and well-established customer base',³⁷¹ albeit in broadband rather than Pay TV. BT did not challenge, in this appeal, Ofcom's assessment in Annex 1 to its Final Statement that BT had developed BT Sport largely to support its broadband business and did not provide us with an alternative explanation for the documents mentioned in that annex. It therefore does not follow automatically from any advantages Sky has in Pay TV that BT has incurred entry costs in the form of start-up losses in sports content that continued into the period covered by the Margin Condition and we have not been persuaded, on the evidence before us, that it has done so.

6.115 We address the arguments set out in RBB Section 5 in our discussion of 3(f) above.³⁷²

6.116 Ofcom pointed to the fact that BT had in fact complied with the Margin Condition to date and had passed the test with some headroom.³⁷³ At its main party hearing, Ofcom explained why it considered this supported its position that it should not make allowance for BT's entry costs:

[...] When we introduced this in March last year, 2015, we again went public and said BT had passed.

We have a process in place for changing the guidance where there's a material change in circumstances, and we've exercised that in UEFA. And in fact we have given BT increased flexibility there.

BT, over the last twelve months, has continued to pass this test and indeed they've continued to pass this test without using the additional flexibility that we've granted them under that UEFA guidance. So it seems very hard for us to sit here and say: this is

³⁷⁰ BT core submission, volume 2, paragraph 208.

³⁷¹ [Final Statement](#), paragraph 7.146.

³⁷² See paragraphs 6.72–6.76.

³⁷³ Ofcom defence (BT Appeal), paragraph 417.

too restrictive for BT. And of course BT, I understand, is sort of saying, well, I could fail in the future.

And what I would say is that that seems almost perverse. The argument here is, I might have to go for low margins in the early part of my business to create a stable business that then gives me profit in the future. Here we have a situation where BT have been comfortably passing this test for the last few years, and it is actually saying, 'As my business goes into the future it's actually going to get worse'. And that is really something we do struggle to accept as being credible.³⁷⁴

6.117 We accept BT's argument in its Core Submission Volume 2³⁷⁵ that it had no option but to set its prices so as to pass the test. However, we note that BT did not provide us with evidence that, in order to comply with the Margin Condition, it had had to put up its retail prices or reduce its wholesale VULA price;³⁷⁶ nor that any such changes had adversely affected its competitiveness in the retail market for SFBB packages.

6.118 At its main party hearing, BT said there were circumstances in which it could have failed the Margin Condition, for example, it pointed to circumstances in which it would have failed the test [redacted] and if it had wished to purchase further packages of FAPL games beyond those it had purchased for the 2016/17 to 2018/19 seasons. BT also said that the Margin Condition could prevent it [redacted]. This would potentially affect the Margin Condition initially as its own revenue [redacted].³⁷⁷

6.119 Ofcom's response to these points was that BT was continuing to spend very large and increasing amounts of money on sports rights, not just for important acquisitions like the Premier League rights, but also smaller but nevertheless still significant rights, such as the next overseas Ashes Series.³⁷⁸

6.120 We consider it is relevant that BT has continued both to spend on sports rights and to comply with the Margin Condition with a degree of headroom; and that it is reasonable to attach some weight to these facts in considering the wider points raised under reference question 3(g).

³⁷⁴ Ofcom hearing transcript (BT Appeal), p117, line 12; p118, line 2.

³⁷⁵ BT core submission, volume 2, paragraph 64.

³⁷⁶ The evidence we have shows that the wholesale price of VULA did not change during the first assessment period. BT did not argue, nor provide evidence to suggest, that it had had to increase its retail prices in order to comply with the condition.

³⁷⁷ Witness statement of John Petter, paragraph 96; BT hearing transcript, p24, lines 1–7 and p107, lines 7–25. [redacted].

³⁷⁸ Ofcom hearing transcript (BT Appeal), p77, lines 6–15.

- 6.121 In its response to our provisional determination, BT expressed concern that, by attaching weight to ‘factual considerations’ including that it was complying with the Margin Condition and that it had continued to invest in sports rights, we had not taken full account of the future risks that Ofcom’s approach could have on its ability to compete in the provision of SFBB bundles and in the provision of sports channels.³⁷⁹
- 6.122 We recognise that the Margin Condition imposes a potential constraint on BT and that there may be some future risks associated with this. BT did not specify in its response the future risks that we had not taken into account. It cross-referred to parts of the witness statements of Mr Tickel and Mr Petter which we have considered under reference question 3(f) above. We note also that the Margin Condition covers the period up to March 2017 and Ofcom will have to re-assess the risks as part of its next market review. We therefore do not accept that we have failed to take account of relevant future risks in assessing BT’s case.
- 6.123 In addressing BT’s arguments in paragraphs 207 to 208 of BT’s Amended Notice of Appeal, Ofcom also stated that BT did not provide evidence that it had actually incurred economic losses.³⁸⁰ Similarly, BT did not provide such evidence to us, see paragraphs 6.99 to 6.100 above.
- 6.124 In its response to our provisional determination, BT said that quantifying the size of economic losses or indirect monetisation was unnecessary because, given Ofcom’s stated regulatory aim in imposing the Margin Condition, it was not necessary to place requirements on BT to earn a defined level of margin on new SFBB customers to contribute towards the net costs of BT Sport. BT said it was incentivised to extract as much value as it could out of its sports content, whether by direct revenues or indirect monetisation. BT also said that, as it did not hold a position of market power in relation to the provision of sports content, its horizontal bundling of its BT Sport channels with broadband services could not be used to distort competition in the provision of broadband. BT added that its position was that a requirement to earn a specific level of margin to cover either indirect monetisation or costs of entry was unnecessary to address concerns with the distortion of competition in the supply of SFBB leading to potential harm to consumers.³⁸¹

³⁷⁹ BT response to our provisional determination, paragraphs 71-72. In paragraph 71, BT identified three general factors: (1) that BT is currently passing the test with headroom; (2) that BT has continued to invest in Sports rights; and (3) that Ofcom has in practice (albeit after the event) provided a degree of flexibility in the way the margin requirement operated for the first 12 months after BT began to supply UEFA content.

³⁸⁰ Ofcom defence (BT Appeal), paragraph 417.

³⁸¹ BT response to our provisional determination, paragraph 95-97 and 100-101.

- 6.125 BT's contention that it is incentivised to extract as much value as it could out of its sports content needs to be considered in light of the current context. It is of particular relevance that BT has SMP in the WLA market and Ofcom found a relevant risk of price distortion due to BT's ability to impose a price squeeze between its VULA wholesale price and the retail price of its SFBB packages.³⁸² Such a price squeeze could arise either from BT charging a low price for SFBB packages relative to the VULA wholesale price, or by BT including free content (for example sports content) with its SFBB packages. It is therefore appropriate for BT's sports content to be taken into account in the Margin Condition that is imposed to address this risk of price distortion.
- 6.126 We also note that Ofcom did not suggest that BT's bundling of BT Sport with SFBB was distorting competition. Indeed, Ofcom told us it had no objection to BT using sports to differentiate its broadband offers and that in some ways this was an innovative approach that brought competitive pressure to bear on other providers of sports content.³⁸³ We agree.
- 6.127 Given that we consider that BT's sports content should be taken into account in the Margin Condition, the issue for us is whether Ofcom's net cost approach is erroneous in how sports content was taken into account. On that matter, we note that Ofcom set out evidence to support its approach (see paragraph 6.96 above) and BT has not provided evidence to us in this appeal that it has incurred start-up losses, see paragraph 6.123 above. Nor have we seen evidence from BT that the value to consumers of BT Sport channels is less than their net cost, see paragraph 6.72 above. We therefore do not consider that Ofcom's net cost approach is erroneous.
- 6.128 BT said that it should only be required to recover the incremental costs of supplying new SFBB customers with access to the channels, ie the costs of supplying access that are directly caused by the newly acquired customers.³⁸⁴ It suggested these were small as its sports costs were largely fixed in nature, and were not part of the relevant LRIC for supplying those customers but formed a significant part of the '+' in the Ofcom test.³⁸⁵
- 6.129 We agree that most of BT's sports costs are fixed in the short term, though they may be avoidable over a longer period, for example once the rights period has expired. However, we have concluded that Ofcom did not err in including fixed and common costs, ie using a LRIC+ basis for the Margin

³⁸² Further, we note that the CAT has dismissed BT's appeal against this finding: *British Telecommunications plc v Ofcom* [2016] CAT 3.

³⁸³ Ofcom hearing transcript, p83, lines 5-9.

³⁸⁴ BT response to our provisional determination, paragraph 96.

³⁸⁵ BT core submission, volume 1, paragraphs 49 to 51, BT response to our provisional determination, paragraph 69(1).

Condition (see paragraph 4.70 above). Therefore, even if most of BT's sports costs are part of the '+' in LRIC+, their inclusion in the Margin Condition is not, in our view, a source of error.

6.130 In its response to our provisional determination, BT said that 'incorporating the fixed costs of rights acquisition into a rigid and bright line margin condition went significantly beyond Ofcom's limited regulatory aim and risked undermining rather than protecting competition in both the short and longer term by constraining competition from BT that the regulatory regime should in reality be seeking to promote'.³⁸⁶

6.131 In relation to BT's arguments on the 'rigid and bright line' nature of the Margin Condition, we have concluded that the interests of enforceability and legal certainty justify the adoption of a bright-line test and that the risk identified by BT that it could be found to be in breach as a result of a very small shortfall in the required margin in only a single month is likely to be satisfactorily managed by the adoption of a longer compliance period.³⁸⁷ Further, we have concluded that Ofcom did not err in including fixed costs in the Margin Condition.³⁸⁸ Finally, on the alleged risk of undermining rather than protecting competition from BT, we accept that the Margin Condition imposes some constraint on BT. Overall, as we conclude in paragraph 6.74, we are not persuaded that BT has demonstrated that the constraints the Margin Condition has imposed on BT are disproportionate to Ofcom's aim in imposing the margin control. We therefore consider that we have assessed and concluded on BT's points in this part of its response to our provisional determination.

6.132 Finally, in its response to our provisional determination, BT argued that we had not properly assessed the economic losses – and therefore potential costs of entry/start-up losses – faced by BT and that these should be based on the costs of supplying the channels net of:

- (a) all direct channel revenues;
- (b) the total monetary value to BT of the additional lifetime margin earned across all products sold to any new BT broadband customers joining BT because of the provision of BT Sport within their bundles; and

³⁸⁶ BT response to our provisional determination, paragraph 70.

³⁸⁷ See paragraph 4.65.

³⁸⁸ See paragraph 6.129.

(c) the total monetary value to BT of the additional margin earned on all products provided to existing broadband customers for an extended lifetime because of the provision of BT Sport within their bundles.

6.133 In our assessment of BT's reference question 3(g), we have considered carefully BT's arguments in its pleadings that it made start-up losses. As a result of our assessment, we agree with Ofcom that BT has not provided evidence that it has incurred start-up losses during the period of the Margin Condition. BT's response to our provisional determination re-stated its view that there were 'potential costs of entry/start-up losses' and proposed how they should be assessed. However, BT's proposed assessment, as summarised in paragraph 6.132 above, was based, in part, on assumptions of errors in Ofcom's approach on, for example, ACL, which we have not found. Further, we note that BT has not carried out such an assessment in support of its appeal nor provided evidence which would quantify the losses it argued it may have incurred. We therefore consider that we have fully assessed BT's case on costs of entry.

Our determination on reference question 3(g): Costs of entry

6.134 We determine that Ofcom did not err, as alleged in reference question 3(g), in not making allowance for the long-term costs of entry that BT alleges it faces in seeking to compete effectively in the provision of sports content.

Reference question 4(c): LRIC+ applied to BT Sport

6.135 In relation to reference question 4(c), BT submitted that Ofcom erred in its approach to applying the LRIC+ cost standard to bundled services, and in particular to bundles including BT Sport. BT said that this was illustrated by Ofcom's treatment of bundled products, and in particular the treatment of BT Sport, where Ofcom required BT to recover, in addition to the incremental costs of its retail SFBB service, a fixed monthly contribution based on the unrecovered costs of its investment in BT Sport, and in particular the investment costs in sports rights. BT cross-referred to its arguments under 3(f) and 3(g).³⁸⁹

6.136 In support of its arguments in reference question 4(c), BT simply referred to its pleadings on reference questions 3(f) and 3(g), as well as 3(a) on LRIC+. We therefore determine that Ofcom did not err on reference question 4(c) for the reasons set out in our assessment of reference questions 3(f), 3(g) and 3(a).

³⁸⁹ BT AmNoA, paragraphs 251 & 252.

Reference question 3(j): Treatment of BT Sport launch costs and marketing costs

6.137 By reference question 3(j), BT alleged errors by Ofcom in its treatment within the Margin Condition of two specific costs for BT Sport: launch costs which BT argued that Ofcom's treatment would result in an over-recovery; and marketing costs which BT alleged Ofcom wrongly treated as an ongoing cost. We consider each separately as they raise distinct and independent points.

Launch costs

6.138 BT Sport launch costs are incorporated into the Margin Condition as part of the net cost of sports calculation, which is then recovered across all SFBB customers. Specifically, the estimated £[redacted]³⁹⁰ total launch costs were converted to a monthly allocation over a five-year recovery period, while maintaining the NPV. This resulted in an ongoing monthly cost of £[redacted]³⁹¹ per month.

Ofcom's approach

6.139 Having noted in the Consultation that BT had incurred costs relating to the launch of BT Sport prior to the market review period, Ofcom set out in its Final Statement how these costs should be incorporated into the Margin Condition. It concluded that the net cost of BT Sport should be uplifted during the period covered by the Margin Condition to reflect the launch costs incurred prior to the review in 2013/14.³⁹² Taking into account BT's response to the Consultation, Ofcom judged that five years was an appropriate period over which to spread these launch costs in the Margin Condition.³⁹³

6.140 Ofcom also set out in the Final Statement how it would estimate these costs. It concluded that it was reasonable to assume that the calculation of the BT Sport channel launch costs should be based on any spend incurred prior to the launch of the channels (ie in 2012/13), as well as the difference in costs between 2015/16 and 2013/14.³⁹⁴

6.141 Ofcom treated these launch costs as applying to each monthly cohort over the whole of its ACL. Ofcom noted that, in the course of the Consultation, BT had argued that this 'may overstate the launch costs as it would assume that any adjustment for launch costs applies in every year of the ACL'. Ofcom

³⁹⁰ Final Statement, Table 6.8, p234.

³⁹¹ Final Statement, Table 6.8, p234.

³⁹² Final Statement, paragraph 6.373.

³⁹³ Ofcom had proposed a three-year recovery period in the consultation.

³⁹⁴ Final Statement, paragraph 6.375.

responded to this point by arguing that its treatment of launch costs was consistent with its overall approach which assumed that the margin BT generated from a cohort remained constant over its ACL. Ofcom went on to state that 'Given the uncertainties in relation to the costs and revenues of BT Sport in the long term, we have not speculated on whether the costs will differ in the future in a way that is not reflected in movements in BT's future pricing'.³⁹⁵

BT's case

6.142 In its Amended Notice of Appeal, BT argued that Ofcom's treatment of launch costs was incorrect, and returned to the point it had made in response to the Consultation about the potential for overstating these costs. It stated the following:³⁹⁶

Over-recovery of channel launch costs. Ofcom's treatment of initial launch costs overstates those costs because it assumes that any adjustment for launch costs applies in every year of the ACL. Ofcom specifically rejected this objection.³⁹⁷ It was wrong to do so, since BT Sport launch costs are spread over 5 years, so that they will be fully recovered by July 2018. However, they are fully incorporated in the monthly net costs of BT Sport for every month of a new customer's 60-month ACL even where those 60 months extend beyond July 2018. This leads to clear over-recovery for any months after July 2018 of between [x] per month. The same issue is likely to recur with UEFA content launch costs.

6.143 In making its case, BT stated the following:³⁹⁸

Taking for example a customer that takes up an SFBB bundle in April 2015. That customer must also recover [a] portion of the BT Sport launch costs from its margin. As the model assumes that customers have an average lifetime of 60 months, that customer needs to recover a portion of the launch costs until March 2020. This is despite the fact that Ofcom explicitly assumed the one off costs would be fully recovered by July 2018. It means that this customer

³⁹⁵ [Final Statement](#), paragraph 6.378.

³⁹⁶ BT AmNoA, paragraph 218(1).

³⁹⁷ [Final Statement](#), paragraph 6.378.

³⁹⁸ First witness statement of James Tickel (BT Appeal), paragraphs 156(d) and 156(e).

contributes to the launch costs for 20 months after the launch costs had been assumed to be fully recovered.

At the extreme it means that a customer acquired in July 2018 will still be required to contribute to the one off launch costs for a further 60 months, despite the fact that the initial launch costs will not be relevant from August 2018 onwards.

Our assessment of launch costs

- 6.144 We consider it relevant that the BT Sport launch costs taken into account in the Margin Condition were incurred prior to the review period. Most other aspects of the Margin Condition involve comparing the revenues and costs associated with a particular cohort of new customers. However, by incorporating costs incurred before the start of the Margin Condition (and hence not directly associated the new cohort of customers), Ofcom needed to make a judgement about how they should be treated within the cohort approach. BT alleged an error in how Ofcom did so.
- 6.145 Ofcom argued that its approach was a reasonable, practical simplification. It stated in its Final Statement and in its Defence, that the treatment of launch costs was a result of its assumption of a constant monthly margin over the ACL. It also made two additional points in its Defence in relation to the fact that there was some uncertainty about the extent to which launch costs might re-occur and therefore what assumptions should be made:³⁹⁹
- (a) Ofcom argued that some launch costs may be re-incurred. Ofcom gave a specific example of [redacted] which made up around [redacted]%⁴⁰⁰ of the £[redacted] total, but stated there may be other costs as well (eg £[redacted]⁴⁰¹ [redacted] which Ofcom considered might be re-incurred). It does not appear to be disputed by BT that there could be some reoccurrence of the costs included within Ofcom's measurement of launch costs.
 - (b) Ofcom argued that, in relation to other elements of the launch costs, the effect of these costs would be expected to diminish over time and would require an element of 'refresh' of this initial expenditure. This could be considered to be a form of re-occurrence. It gave the example of BT's marketing costs at the point of launch which make up [redacted]%⁴⁰² of the £[redacted] total.

³⁹⁹ Ofcom defence (BT Appeal), paragraph 506.

⁴⁰⁰ Final Statement, Tables 6.7 & 6.8, pp233–234.

⁴⁰¹ Final Statement, Table 6.6, p232.

⁴⁰² Final Statement, Tables 6.7 & 6.8, pp233–234.

- 6.146 Ofcom observed in its Final Statement that BT did not typically distinguish between ongoing costs and one-off costs and the information submitted in this appeal suggests to us that it is difficult to do so. There are some examples of launch costs which are likely to be truly 'one-off', such as [redacted]. Others represent an unusually large level of spend in a category of costs which are also incurred on an ongoing basis. These may fall into the category of costs where some decay of the value over time may occur in practice.
- 6.147 The inherent uncertainty over what costs will re-occur means that while Ofcom's approach may result in some over-recovery, the alternatives may risk under-recovery. For example, by assuming such costs should be removed from July 2018 onwards, this would result in any such re-occurrence of expenditure being excluded from the current cohort's cost stack. This is because, even if these costs were captured in the Margin Condition at the point of reoccurrence, this would only apply to cohorts after that point. Therefore, if these costs did re-occur, there would be an under-recovery from current cohorts.
- 6.148 There is sufficient uncertainty about the nature of these launch costs that they should not be seen as entirely one-off costs. Given that Ofcom is applying historical costs from before the review period to the Margin Condition, we agree that it appears to be a reasonable and practical simplification to convert these costs to a monthly amount and apply them to each new cohort.
- 6.149 Further, while we recognise, as BT argued, that there are differences between forecasts and known changes, Ofcom's treatment of launch costs is broadly consistent with its assumption of a constant margin. We have taken into account Ofcom's arguments that it would be inappropriate to make an adjustment in future margin for one 'known' future change, when there are other 'known' changes which are not taken into account. Ofcom provided the example of the [redacted]. These costs are not included in the cost stack for customers acquired prior to August 2016 even though they might be seen as relevant to those customers whose ACLs will extend beyond that date.
- 6.150 Ofcom accepted that its treatment of launch costs represented a simplification. However, its decision was based on a judgement about which approach was the most appropriate. Given the complexities of identifying a 'correct' approach to these launch costs, and their scale, and taking into account the consistency of its approach with other costs, we consider BT has not shown such a judgement to be wrong.

Marketing costs

Ofcom's approach

- 6.151 Ofcom's guidance in its Final Statement resulted in different treatment of BT Sport marketing costs (excluding launch) and non-Sport marketing costs.
- 6.152 When discussing BT's general marketing costs (ie not specifically for BT Sport) in its Final Statement, Ofcom recognised that a proportion of the costs were likely to be associated with the acquisition of new SFBB customers, and some would be associated with retaining existing customers.
- 6.153 Specifically, the general marketing spend associated with acquiring new SFBB customers was treated as being 'upfront', and so was recovered from the new cohort of SFBB customers across their ACLs. This included marketing and advertising spend aimed at both:⁴⁰³
- (a) [redacted]; and
 - (b) [redacted].
- 6.154 The remaining general marketing spend was treated as 'ongoing' and so was recovered on a monthly basis from across the whole SFBB customer base. This included:⁴⁰⁴
- (a) [redacted]; and
 - (b) [redacted].
- 6.155 However, Ofcom did not explicitly discuss BT Sport marketing costs in its Final Statement. Instead, Ofcom discussed a wider categorisation of BT Sport SG&A costs (of which marketing costs are a subset), stating that it would calculate each SG&A cost item in any given compliance period based on the average historical costs for that item in the six months up to and including that compliance period.⁴⁰⁵ This resulted in treating all of these costs as 'ongoing'.

BT's case

- 6.156 In its Amended Notice of Appeal, BT argued that Ofcom's treatment of BT Sport marketing costs was incorrect, and stated that:

⁴⁰³ Final Statement, Annex 3, paragraphs 3.64 & 3.65 and Guidance Table 3.

⁴⁰⁴ Final Statement, Annex 3, paragraph 3.46 and Guidance Table 1.

⁴⁰⁵ Final Statement, paragraph 6.368; Annex 3, paragraph 3.50.

Treatment of BT Sport marketing costs. Ofcom's treatment of BT Sport marketing costs as an 'ongoing cost' is inconsistent with the approach taken to marketing costs elsewhere in Ofcom's model as 'upfront costs' [...]. The treatment of marketing costs as 'upfront costs' to be recovered over time across all relevant acquired customers, rather than as a fixed ongoing cost of supplying the channels to a specific monthly SFBB cohort over the ACL of that cohort would eliminate the monthly seasonality discussed above and the attendant significant impacts on the monthly cohort margin requirement. Ofcom's approach therefore not only produces a disproportionate result (including because there was a less restrictive alternative to treat them as 'upfront costs'), but also demonstrates regulatory inconsistency on Ofcom's part (there being no proper basis for Ofcom's divergent approach to the marketing costs of BT Sport).⁴⁰⁶

6.157 Again, BT further submitted:

As such, marketing costs in the calculation of the net costs of Sport are treated differently to marketing costs in the rest of the VULA margin model. In the rest of the VULA margin model marketing costs are treated as an upfront customer acquisition cost (see paragraph A3.65 and Guidance table 3 in the Guidance) that needs to be recovered over the customer's average lifetime of five years. Ofcom also identifies the annual marketing spend and uses corresponding acquisition volumes to give a 'marketing spend per acquired customer' figure. Any 'seasonality' in the phasing of marketing spend across the year would not impact the calculation. Such an approach should also be taken in the net cost of BT Sport calculation. Marketing spend for BT Sport is incurred to both attract new customers to the channel and to drive existing customers towards the channels (with benefits for advertising revenue and increasing perceptions of the channels' value). Treating marketing costs as an average upfront cost of acquisition (based on annual spend and annual acquisitions) to be recovered over time across all relevant acquired customers, rather than as a fixed ongoing cost of supplying the channels to the SFBB cohort over their life (based on marketing spend in the month they were acquired) would also eliminate the monthly

⁴⁰⁶ BT AmNoA, paragraph 218(2).

seasonality shown above that, as shown, can have significant impacts on the monthly cohort margin requirement.⁴⁰⁷

Our assessment of marketing costs

6.158 First, we consider BT's point that Ofcom was inconsistent in treating BT Sport marketing costs differently from BT's non-Sport marketing costs.⁴⁰⁸ There appears to be common ground between the parties that, in principle, a proportion of BT Sport marketing costs might be allocated to acquisition of SFBB customers, and a proportion to retention. This is characterised in the pleadings as a difference between the costs being treated as 'upfront' (related to acquisition) and 'ongoing' (related to retention).

6.159 While we agree with this in-principle allocation, we have not seen evidence that there was a sufficient basis for Ofcom to split BT Sport marketing costs in this way. BT relied on a spreadsheet that was filed with Ofcom's Defence in this appeal. BT stated that this showed that over [X] % of the BT Sport 2014/15 marketing budget was dedicated to customer acquisition.⁴⁰⁹ However, we agree with Ofcom that it is not clear what this data represents. In particular, it is unclear whether these figures represent spend associated with the acquisition of SFBB customers, or if they include other sport-related acquisitions that are not relevant to the Margin Condition (eg a BT Sport customer that does not have BT broadband, or pubs/clubs).⁴¹⁰ Further, we consider that it is relevant that BT did not challenge Ofcom's approach during the Consultation, and that the information it now relies on to allege an error was not available to Ofcom at the time it made its final decision. Since it did not have access to equivalent data, we do not consider that Ofcom was inconsistent in its treatment of BT Sport marketing costs compared to other marketing costs.

6.160 BT made two additional points in support of this reference question:

(a) It argued that 'treating marketing costs as an average upfront cost of acquisition would also eliminate the monthly seasonality'. We consider the issue of the seasonality of BT Sport costs (including marketing) in our assessment of reference question 3(f). However, we note that a change of treatment of BT Sport marketing costs from ongoing to upfront does not have a simple effect on seasonality. This is because although the upfront

⁴⁰⁷ First witness statement of James Tickel (BT Appeal), paragraph 157(b).

⁴⁰⁸ BT appears to be incorrect in its statement that all the non-Sport marketing costs were treated as upfront. Instead it appears that Ofcom treated a proportion of non-Sport marketing costs as being upfront, and a proportion as being ongoing.

⁴⁰⁹ BT core submission, volume 2, paragraph 244.

⁴¹⁰ Ofcom response to CMA Question Set 01, 9 February 2016; Ofcom hearing transcript (BT Appeal), pp50–52.

approach would recover the costs across the ACL, it does so only from the new cohort of customers rather than the full SFBB base. Since the number of new customers in a given period is likely to vary substantially more than the overall customer base, it is not clear that this would reduce seasonality.

- (b) BT argued that Ofcom's approach was disproportionate as there was a less restrictive alternative. However, as we set out in paragraph 6.159, we consider that BT did not provide a sufficient basis for allocating BT Sport marketing costs between ongoing and upfront, so an alternative approach is not clear. Also, although adopting an upfront approach would allow for recovery over the ACL, it would do so from a smaller set of customers (only the new cohort). Therefore, it is not clear that an upfront approach is necessarily less restrictive than an ongoing approach.⁴¹¹

Our determination on reference question 3(j): Treatment of BT launch costs and marketing costs

6.161 For the reasons set out in paragraphs 6.158 to 6.160 above, we determine that Ofcom has not erred in its treatment of BT Sport channel launch costs or BT Sport marketing costs.

Reference questions 3(i) and 5(b): The value-based approach

6.162 In this section, we consider BT reference questions 3(i) and 5(b). These relate to the approach taken by Ofcom in the VULA margin test in respect of the supply of sports content by BT and, in particular, whether or not Ofcom erred by not applying a 'value-based approach'.

6.163 The reference questions are the following:

- (a) **Reference question 3(i)** – Did Ofcom err by rejecting a value-based approach to the application of the Price Control to the supply of sports content by BT, for the reasons set out in paragraphs 162(i) and 213 to 217 of BT's Amended Notice of Appeal?
- (b) **Reference question 5(b)** – Whether the terms of the Price Control are in breach of the principle of proportionality that is applicable to such conditions as a general principle of EU law and pursuant to Article 8(4) of the Access Directive, having regard to the 'value approach' put forward by

⁴¹¹ Ofcom's Defence (BT appeal), footnote 111. Ofcom provided an illustrative example showing that the implied revenue requirements on BT to ensure it was compliant under the two approaches was depended on the number of new SFBB customers compared with the size of the overall base.

Compass Lexecon, for the reasons set out in paragraphs 273(b) and 280 to 281 of BT's Amended Notice of Appeal?

- 6.164 A value-based approach is based on the premise that the value placed on BT Sport content by customers determines the competitive impact of the provision of that content rather than the cost BT incurs to acquire and distribute it. This contrasts with the approach adopted by Ofcom which is based on the actual costs of BT Sport.
- 6.165 BT proposed a specific alternative value approach in a report by Compass Lexecon dated 5 September 2014. Compass Lexecon stated that for competitors to be excluded from the market, they must be unable to offer sufficient value to achieve minimum efficient scale (MES). Compass Lexecon first considered whether the margin was sufficient to recover the costs of BT Sport (an assessment of 'sacrifice'), but also considered whether rivals needed to offer additional value to their broadband package to achieve MES (an assessment of 'exclusion').⁴¹²

Ofcom's approach

- 6.166 Ofcom's Final Statement concluded that 'under current circumstances a net cost approach is the most appropriate approach to including BT Sport in the VULA margin assessment'.⁴¹³
- 6.167 Ofcom considered and rejected Compass Lexecon's alternative 'value approach' submitted by BT during the Consultation.⁴¹⁴ Ofcom also rejected BT's submissions during the Consultation that Ofcom's net costs approach may result in 'excess margin' for BT's rivals.⁴¹⁵

BT's case

- 6.168 BT submitted in its Amended Notice of Appeal:

Ofcom's approach also discloses a material error in setting out its conceptual approach to the assessment of the provision of BT Sport to BB customers, Ofcom expressly dismissed BT's proposal, based on the CL Report, that Ofcom should adopt a value based, rather than cost-based approach to this exercise.⁴¹⁶

⁴¹² Compass Lexecon Report, 5 September 2014, paragraph 17: Annex to first witness statement of James Tickel (BT Appeal).

⁴¹³ [Final Statement](#), paragraph 6.250.

⁴¹⁴ [Final Statement](#), paragraph 6.257.

⁴¹⁵ [Final Statement](#), paragraphs 6.262 & 6.263.

⁴¹⁶ BT AmNoA, paragraph 213.

6.169 BT argued that, while Ofcom's approach was exclusively focused on assessing 'sacrifice', this was insufficient to determine actual or likely exclusion of competitors. BT went on to state that it was the value placed by consumers on the BT Sport content, rather than the cost that BT incurred to acquire and distribute it, that determined the competitive impact of the provision of that sports content. It made the following points:⁴¹⁷

The provision of BT Sport for no additional payment to SFBB customers is akin, conceptually, to providing a voucher for any kind of product or service. However, the value placed on a BT Sport 'voucher' is subjective, and varies widely amongst consumers. The **cost** of sports content does not equate to the **value** to individual consumers of such content (and it is the value of the content that other CPs must be able to replicate in order to compete with BT). ...

Ofcom is therefore wrong to assume that costs equal value. Furthermore, it is relevant that due to the nature of the Pay TV market the cost of sports content has increased dramatically over time and may well continue to do so. However the nature and quality of the content is largely unchanged. As such, value rather than cost is a more predictable measure over time...

The right to show certain sports content is (for defined periods) exclusive to BT. Competitors cannot replicate BT's offering – but they do not need to so in order to compete with BT in the supply of SFBB...The facts pertaining here differ from the standard margin squeeze paradigm, and are what make a value-based test more appropriate...

The cost of sports content would only be potentially relevant as part of an assessment that considered both 'sacrifice' and 'exclusion', if BT's competitors are required to attract a particular class of SFBB consumers who place a high value on the BT Sport content in order to be effective competitors. That is not the case...

If BT's competitors do not need to attract any consumers who place a positive valuation on sports content then sports costs should be excluded.⁴¹⁸

⁴¹⁷ BT AmNoA, paragraph 215.

⁴¹⁸ BT AmNoA, paragraph 215; emphasis in original.

6.170 BT also submitted that not adopting a value based approach led to ‘illogical and perverse effects’ and made the following points in support:

The principal failing of Ofcom’s ‘net cost approach’ is that, taken to its logical extreme, the test assumes that a service valued and taken by only an insignificant number of users could affect downstream rivals’ ability to compete, which is nonsense. Indeed, Ofcom’s approach leads to the obviously paradoxical and absurd consequence that the less valuable BT’s investment turns out to be, and thus the greater the loss that needs to be recovered from its SFBB customers in any month, the higher BT must set its retail prices in order to recover those losses:

Ofcom’s net costs approach risks providing excess margin and therefore allows for inefficient downstream entry and reduces incentives for competitors to invest in their own fibre networks

The provision of excess margin would also reduce BT’s ability to bid for sports rights in the future, and undermine its ability to monetise sports rights that it does acquire.⁴¹⁹

6.171 Finally, BT submitted that the ‘value approach’ advocated by Compass Lexecon avoided the above results and also addressed the concerns of the Commission.⁴²⁰

Our assessment of reference questions 3(i) and 5(b): The value-based approach

6.172 We first consider the parties’ arguments about the relevance of cost and value in designing the Margin Condition. We then address some of the specific issues raised by Ofcom in its Defence on the practicability of the Compass Lexecon approach. BT has two ‘key criticisms’ of Ofcom under reference question 3(i). The first is that Ofcom’s approach ‘is insufficient to determine actual or likely exclusion of competitors’,⁴²¹ and the second is that ‘not adopting a value-based approach leads to illogical and perverse effects’.⁴²² We deal with BT’s contention about ‘perverse effects’ of using the net costs of sport in paragraphs 6.65 to 6.74 above.

6.173 Our assessment of BT’s first ‘key criticism’ under reference question 3(i) is that it is based on two arguments:

⁴¹⁹ BT AmNoA, paragraph 216; references omitted.

⁴²⁰ BT AmNoA, paragraph 217.

⁴²¹ BT AmNoA, paragraph 215.

⁴²² BT AmNoA, paragraph 216.

- (a) Ofcom was wrong to rely on the cost of BT Sport provision, since the costs of BT Sport are not relevant because the competitive impact of BT Sport depends on its value.
- (b) Ofcom should have considered whether the provision of BT Sport was necessary for competitors to compete effectively with BT. This is characterised in BT's pleadings as the need for MES.

6.174 We consider these arguments in turn.

The relevance of the costs of sport

6.175 As part of its first key criticism of Ofcom's approach, BT stated that it was the value placed by consumers on BT Sport content, rather than the costs that BT incurred, that determined the competitive impact of the provision of sports content.⁴²³ In the extreme case, if BT Sport was valued by only an insignificant number of users, it had no effect on competition and so rivals did not need any contribution of BT Sport in the VULA margin in order to compete. In such a case, BT submitted that the costs of sport should be excluded from the Margin Condition.⁴²⁴

6.176 Both Ofcom, in its Defence, and Sky in its intervention, questioned the extent to which a value approach was consistent with the EEO standard. Sky submitted the following:

The cost-based approach adopted by Ofcom allows different communications providers to compete on the basis of differing bundles which offer the same value to consumers. But in order to enable an EEO to offer bundled SFBB on a level playing field, it must be given the opportunity to offer bundled services that consumers value just as much as BT's bundled services (even if this does not involve replicating those services).⁴²⁵

6.177 Sky further submitted that the cost-based approach fully took into account the role of consumers' valuation of the additional content bundled with broadband by BT.⁴²⁶ At BT's main party hearing, Dr Caffara, on behalf of Sky, described the principle that competition between bundles is based on customers' valuation not their cost as a 'truism'.⁴²⁷ She understood the EEO concept to

⁴²³ BT AmNoA, paragraph 215.

⁴²⁴ BT AmNoA, paragraph 216(1); BT hearing transcript, p111, line 26 to p112, line 1.

⁴²⁵ Sky Statement of Intervention (Sol), paragraph 75.3.

⁴²⁶ Sky Sol, paragraph 75.2.

⁴²⁷ Sky hearing transcript (BT Appeal), p5, line 9.

be a benchmark: 'someone who is capable of offering consumers equivalent surplus above the price for what is being offered'⁴²⁸. The surplus was the difference between customers' value of a product and the price of that product. The maximum price a rival could offer was 'a price that is equal to the price of the integrated firm plus whatever additional value the rival may be able to create, with the additional features he can bundle into the product',⁴²⁹ although these features may not be identical. The test required that the additional surplus be created efficiently, which means 'surplus must be offered for a cost that is comparable'.⁴³⁰ It followed that the value of the SFBB bundle was included in the test: 'it is inherent in the definition of an equally efficient operator in this context, that he must be able to offer equivalent value. That value must be offered at a cost that is comparable and therefore it boils down to that cost being in the formula'.⁴³¹

6.178 We consider these points to be persuasive. BT's response, in its Reply, that Ofcom 'depart[s] from any assessment of the "real world" does not, in our view, undermine these points'.⁴³² We understand that BT does not challenge the EEO approach, which is necessarily a hypothetical construct. We are persuaded that Ofcom's approach correctly reflects the concept of an EEO. An EEO benchmark uses the costs of BT, as the vertically integrated operator firm with upstream SMP, as the benchmark. As a result, if a rival to BT can achieve greater value at the same or less cost, or the same value at less costs, it will win more customers, as it should as it is a more efficient operator than BT. The EEO approach therefore gives BT's rivals the same opportunity as BT to create value.

6.179 One question here is how to apply the EEO approach if the regulated firm makes investment costs it needs to recover over a substantial period of time. In such a situation, the regulated firm has high costs relative to value in one period, and high value relative to cost in another period. One possibility is to allow costs to be recovered in future periods and so not to consider the net costs statically in each period. A regulator would then consider how a hypothetical operator would repay its investment costs over time.

6.180 We conclude, however, that for such a concern to be relevant to BT we would need to be persuaded that it has large unrecovered investment costs it seeks to recover over the long term. As discussed in paragraphs 6.87 to 6.101, we have not been persuaded that this is the case in relation to BT.

⁴²⁸ Sky hearing transcript (BT Appeal), p6, lines 21–22.

⁴²⁹ Sky hearing transcript (BT Appeal), p7, lines 2–4.

⁴³⁰ Sky hearing transcript (BT Appeal), p7, lines 12–13.

⁴³¹ Sky hearing transcript (BT Appeal), p7, lines 20–23.

⁴³² BT core submission, volume 2, paragraph 229.

6.181 In its response to our provisional determination, BT said the following:

To the extent that the CMA does not accept BT's logic in challenging the need to define a specific margin requirement in relation to the fixed costs of BT Sport, BT's position is that Ofcom should allow some specific consideration of the value of BT Sport to be made before any conclusion was reached that failure of the test, as designed, would distort competition and harm consumers.⁴³³

6.182 Our assessment of BT's submissions on the need for Ofcom to carry out an additional assessment of the effect on competition if BT breaches the Margin Condition are in Section 4. Additionally, as discussed in paragraphs 6.188 to 6.192, there are practical problems in measuring the value of BT Sport to consumers.

Minimum efficient scale

6.183 We consider in this section the argument that it is only necessary for BT's rivals to achieve minimum efficient scale. Specifically, BT submitted that 'if its competitors do not need to attract any consumers who place a positive valuation on sports content, then sports costs should be excluded'.⁴³⁴ This was because the provision of sports content cannot undermine the ability of competitors to compete effectively with BT.⁴³⁵ For example, the Compass Lexecon approach interpreted the exclusion test as ensuring BT's rivals attained MES. By the design of Compass Lexecon's approach, the customers required to attain minimum efficient scale are only those who place a low value on BT Sport.

6.184 Ofcom submitted that as a result of this feature, the Compass Lexecon approach would allow BT to use its market power in WLA to set the VULA margin at a level that would not allow even BT (ie as an EEO) to compete profitably for customers beyond the MES.⁴³⁶ Ofcom submitted that its regulation sought to address broader risks than ensuring all of BT's rivals attain MES, in that competition on the merits required that a more efficient retail competitor than BT ought to be able to compete for customers across

⁴³³ BT response to our provisional determination, paragraph 102.

⁴³⁴ BT AmNoA, paragraph 215(5).

⁴³⁵ BT AmNoA, paragraph 215(5).

⁴³⁶ Ofcom defence (BT Appeal), paragraph 478.

the market, not simply up to the volumes necessary to achieve minimum efficient scale.⁴³⁷

- 6.185 We agree with Ofcom's assessment of the consequences for its regulatory objectives of adopting a value approach. We note that BT did not comment on this concern in its Core Submission, Volume 2 and, when put to it at its main party hearing,⁴³⁸ BT criticised it as 'a very theoretical argument'⁴³⁹ given current market shares in the market for Pay TV.
- 6.186 We do not consider the argument to be overly theoretical given the fact that BT can control an important input into the cost of its competitors' SFBB bundles. We conclude that by focusing in a value approach on exclusion from the market as a whole, BT's alternative is limited to ensure that BT's rivals can achieve MES. This focus would effectively exclude its rivals from a subset of the market, namely from those customers who place a high value on BT Sport. We accept Ofcom's submission that the Margin Condition seeks to address the broader issue of competition on the merits across the whole market.⁴⁴⁰
- 6.187 Finally, we note that the Compass Lexecon approach uses the lower of value and cost,⁴⁴¹ so if the value was greater than the cost then BT would not contest the costs approach. Therefore, the value approach is predicated on the claim that the value of BT Sport to BT Sport customers is less than its cost to BT. Taking into account our conclusions on the other reference questions related to BT Sport, we note that BT has not demonstrated that this is the case.

Practicability of the Compass Lexecon approach

- 6.188 While we consider there are in-principle reasons for rejecting a value-based approach, we nevertheless consider, for completeness, the specific value approach proposed by BT (ie the Compass Lexecon approach) as an alternative in relation to reference question 5(b).
- 6.189 Ofcom argued that Compass Lexecon had significantly understated the practical difficulties of implementing its exclusion assessment.⁴⁴² In particular, Ofcom submitted that Compass Lexecon did not suggest a practical way to

⁴³⁷ Ofcom defence (BT Appeal), paragraph 479a.

⁴³⁸ BT hearing transcript, p113, line 18.

⁴³⁹ BT hearing transcript, p114, line 2.

⁴⁴⁰ Ofcom defence (BT Appeal), paragraph 479a.

⁴⁴¹ Compass Lexecon report paragraph 50, Annex to first witness statement of James Tickel (BT Appeal).

⁴⁴² Ofcom defence (BT Appeal), paragraph 486.

measure MES (and moreover the overall pool of contestable customers); and the effectiveness of price discrimination.

6.190 Sky made a similar point in its intervention:

The costs incurred in providing a service are clearly ascertainable [...] In contrast, consumer valuations of a service are variable, heterogeneous and difficult to quantify [...] BT's approach would presumably require Ofcom to carry out a series of consumer surveys on a sampled basis. That survey would have to be replicated for each bundle of services that BT offered and each time the content of the services changed.⁴⁴³

6.191 We consider it relevant to our assessment that BT's Core Submission, Volume 2 does not engage with the practical issues raised by Ofcom.⁴⁴⁴ Further, we are persuaded by Ofcom's and Sky's submissions. In practice, we consider that any of these estimated parameters would be highly contentious and would lead to further appeals and re-estimations by all the parties affected by their use.

6.192 We conclude that these problems are significant and that Ofcom was not wrong to take them into account when rejecting the value approach proposed by Compass Lexecon. It follows that we are not persuaded that the Compass Lexecon report is an appropriate way to address any concerns of the Commission, as BT argues.

Our determination on reference questions 3(i) and 5(b): The value-based approach

6.193 For the reasons set out in paragraphs 6.172 to 6.192, we determine that, in relation to reference question 3(i), Ofcom did not err by rejecting a value-based approach to the application of the Margin Condition to the supply of sports content by BT. Further, in relation to reference question 5(b), we determine that the terms of the Margin Condition are in not breach of the principle of proportionality that is applicable having regard to the 'value approach' put forward by Compass Lexecon.

Reference questions 3(h), 4(h) and 5(c) - the Pay TV approach

6.194 Reference questions 3(h), 4(h) and 5(c) each relate to a comparison between Ofcom's treatments of BT Sport costs in its approach to the Margin Condition

⁴⁴³ Sky Sol, paragraphs 76.1 & 76.2.

⁴⁴⁴ Ofcom defence (BT Appeal), paragraph 236.

compared with its approach to costs of entry in the Pay TV statement. In these reference questions BT alleges that Ofcom:

- (a) erred in adopting an approach to BT's costs of entry in the provision of sports content that is inconsistent with the Pay TV statement (reference question 3(h));
- (b) erred in imposing a regulatory condition on BT that discriminates unduly against BT, by comparison with the approach taken to Sky in respect of Pay TV (reference question 4(h)); and
- (c) is in breach of the principle of proportionality having regard to the approach adopted by Ofcom itself in the Pay TV statement (reference question 5(c)).

6.195 These three questions are categorised such that reference question 3(h) is a flaw in the design of the Margin Condition, reference question 4(h) is an error in principle, and reference question 5(c) is an alternative approach to the Margin Condition.

Background to the Pay TV approach

6.196 In 2010, Ofcom concluded a review of the Pay TV market which identified competition concerns arising from Sky's practices in the supply of premium sports content. Ofcom decided to impose a wholesale must offer (WMO) obligation on Sky under section 316 of the Act to address those concerns.⁴⁴⁵

6.197 The WMO obligation required Sky to offer to wholesale its Sky Sports 1 and 2 (SS1&2) channels to other Pay TV retailers with certain prices and terms set by Ofcom.⁴⁴⁶

6.198 Ofcom's model was of a hypothetical new entrant to retail Pay TV,⁴⁴⁷ seeking to establish its own Pay TV platform, but not investing in premium sports content.⁴⁴⁸ The modelling was based on Sky's own costs and retail prices and assessed the margin that a new Pay TV retailer, on an REO basis, would require on the SS1&2 channels.

6.199 This broadly compares with the Margin Condition, where Ofcom models a retailer that has the same downstream business as BT (subject to certain adjustments). Ofcom's general approach to the VULA model is described in

⁴⁴⁵ [Ofcom's review of WMO Statement](#) (November 2015), paragraph 1.1.

⁴⁴⁶ Ofcom set a maximum wholesale price for the SS1&2 channels.

⁴⁴⁷ In other words not the incumbent, Sky, but a theoretical new entrant to the market.

⁴⁴⁸ Ofcom defence, paragraph 4.53(a).

paragraphs 1.22 to 1.29 above and its approach to BT Sport costs is described in paragraphs 6.3 to 6.8 above.

6.200 The WMO obligation was removed in November 2015 following a review by Ofcom which found that Sky is supplying its content widely.⁴⁴⁹ Ofcom's WMO decision in the Pay TV statement has been subject to various appeals. The withdrawal of the WMO obligation has most recently been appealed by BT and is currently under consideration by the CAT.⁴⁵⁰

BT's case

6.201 BT argued that in the Margin Condition, Ofcom's treatment of BT's cost of entry into the provision of sports content was in 'stark contrast' to the approach Ofcom adopted when setting WMO prices in the Pay TV statement.⁴⁵¹ It further contended that there was an inconsistency between the standards that Ofcom had applied in respect of the two different regulatory models (ie in relation to Pay TV and VULA), despite both being based on a retail minus approach.⁴⁵²

6.202 In particular, BT highlighted that the WMO approach taken to modelling the hypothetical new Pay TV entrant had the following characteristics, none of which were included within the approach to the Margin Condition:⁴⁵³

- (a) A DCF forecast basis.
- (b) A basis that a new entrant would need to allow for significant losses in the first years after entry, and possibly more than ten years.
- (c) Rejection of any adjustments to Sky's ACL.
- (d) Treatment of upfront costs as sunk costs, excluding them from the calculation.⁴⁵⁴

6.203 BT stated that the WMO DCF calculation included an explicit forecast of the hypothetical entrant's costs and revenues over a ten year period, and assumed that annual cash flows grew in line with inflation thereafter.⁴⁵⁵ BT noted that the VULA margin model was static and based on historic costs and revenues.

⁴⁴⁹ [Ofcom's review of WMO Statement \(2015\).pdf](#), paragraph 1.24.

⁴⁵⁰ [British Telecommunications plc v Office of Communications \(WMO\)](#).

⁴⁵¹ BT AmNoA, paragraph 210.

⁴⁵² First witness statement of James Tickel (BT Appeal), paragraph 169.

⁴⁵³ BT AmNoA, paragraph 211.

⁴⁵⁴ First witness statement of James Tickel (BT Appeal), paragraph 175.

⁴⁵⁵ First witness statement of James Tickel (BT Appeal), paragraph 168.

- 6.204 BT explained that the WMO price was set such that a new entrant retailer of premium sports would make significant initial losses over a sustained period. It compared this with the Margin Condition, which it argued expected BT to recover its short-term losses on Pay TV and BT Sport in the short run from its broadband products. BT emphasised that in the Margin Condition, all costs were budgeted for recovery in the short term, effectively requiring that the full value of observed losses on BT Sport were recovered from the monthly cohort margin.
- 6.205 BT noted that Ofcom did not take any account of the fact that those losses would reflect BT's position as a recent entrant into the provision of sports content⁴⁵⁶ and did not recognise that early losses would be expected in the retailing of premium sports channels as Ofcom had assumed in the context of the hypothetical entrant into Pay TV within the WMO remedy.
- 6.206 BT noted that in the WMO remedy, Ofcom had rejected an adjustment to Sky's churn rate,⁴⁵⁷ which BT said was in 'stark contrast' to Ofcom's decision to adjust BT's ACL downwards.⁴⁵⁸
- 6.207 BT also noted that Ofcom excluded from the WMO calculation any one-off costs associated with the start-up of a new entrant, regarding WMO upfront costs as sunk costs, but the VULA model required upfront costs to be fully recovered within the first five years of BT Sport's existence.⁴⁵⁹
- 6.208 BT reiterated that it was a relatively new market entrant on upstream and downstream markets that were dominated by Sky, and remained at a competitive disadvantage in the Pay TV sector. BT said it invested heavily in acquisition of sports rights in order to challenge Sky's entrenched position in the Pay TV sector.⁴⁶⁰
- 6.209 BT argued that 'given the obvious and increasingly important overlaps between the bundled offerings incorporating Pay TV and retail broadband services, it was unreasonable for Ofcom to adopt different regulatory principles in respect of BT and Sky's pricing for the upstream inputs into the retail broadband market over which they were, respectively, found to have significant market power'.⁴⁶¹

⁴⁵⁶ First witness statement of James Tickel (BT Appeal), paragraph 164.

⁴⁵⁷ First witness statement of James Tickel (BT Appeal), paragraph 172.

⁴⁵⁸ First witness statement of James Tickel (BT Appeal), paragraph 174.

⁴⁵⁹ First witness statement of James Tickel (BT Appeal), paragraph 175.

⁴⁶⁰ BT AmNoA, paragraph 45(4).

⁴⁶¹ BT AmNoA, paragraph 279.

Our assessment of reference questions 3(h), 4(h) and 5(c): the Pay TV approach

- 6.210 Reference questions 3(h), 4(h) and 5(c) rely on the circumstances around the VULA margin and WMO regulations being comparable situations and we note there are a number of recognised similarities between them. In both cases the regulation is a retail-minus price control aimed at preventing the incumbent from earning too small a margin and thereby distorting competition in retail markets. Both cases also have regard to a new or ‘relatively’⁴⁶² new entrant to a Pay TV service (in the WMO case, a hypothetical entrant into Pay TV retailing and in the VULA case, a relatively new entrant into the provision of sports content)
- 6.211 We note that in its November 2015 review of the WMO obligation, Ofcom stated that it considered BT to be a ‘recent’ and ‘relatively new’ entrant to the Pay TV sector.
- 6.212 However, there are also a number of key differences. The two markets being compared are at different stages of development. The retail broadband market is well established with a number of key competitors, of which BT is dominant in the wholesale market. Within the broadband market is the new SFBB product, launched by BT, which is creating changes to the competitive dynamic. This is in contrast to the situation in the Pay TV market at the time of the introduction of the WMO condition where the product itself was well-established but there were few established competitors and Sky retained dominance in both the wholesale and retail markets. We note in this regard that Sky, in its Statement of Intervention, stated that ‘The Pay TV sector is governed by a separate regulatory framework. It relates to a different product market with different conditions of competition.’
- 6.213 In the context of these differences, Ofcom’s approach to modelling the regulatory remedies in the two markets was different. In the WMO obligation, a REO model was used, ie a new reasonably efficient entrant into Pay TV. For the Margin Condition it is an EEO standard that has been used, ie an established business of comparable scale to BT. Since BT is bundling BT Sport with broadband, the modelling of the EEO includes modelling of the net cost of BT Sport. The modelling of BT Sport in the Margin Condition is therefore not directly comparable to the hypothetical new entrant into Pay TV modelled in the WMO remedy because it is part of a bundled offering by an established operator, not a standalone new entrant.

⁴⁶² BT AmNoA, paragraph 45(4).

- 6.214 Further to this, the focus in the Margin Condition is the measurement of incumbent's costs and what could be achieved by existing competitors, with BT's sport broadcasting included as one of its products. In the WMO obligation the focus was a new entrant's costs and the level at which the wholesale price of sports channels needed to be set to allow (long-term) profitability of the entrant. The purpose for measuring the cost of the entrant into sports content retailing is different between these two circumstances.
- 6.215 BT raised four specific points in relation to the WMO approach which it said were relevant to its case on the Margin Condition: a DCF analysis; allowing losses in the first years after entry; an ACL adjustment; and the treatment of upfront costs. We consider BT's arguments on these points in relation to the reference questions in which the specific errors in these areas are alleged.⁴⁶³ Due to the differences in the circumstances as set out above, we do not consider that the different approach taken by Ofcom in Pay TV is a material point in our considerations of these issues.
- 6.216 BT also made a broader point of regulatory principle about the different way that Ofcom had approached the two models as a whole. In its Core Submission Volume 2, BT alleged that in the WMO case, Ofcom noted it had found strong evidence that competition was actually harmed,⁴⁶⁴ but decided to impose 'light-touch' regulation. BT compared this to the present case, where Ofcom had 'no evidence of competition actually being harmed and a speculative theory as to the risk of harm in the future, but nonetheless it imposed highly intrusive and detailed regulation'.⁴⁶⁵
- 6.217 Ofcom defended the difference in approach by highlighting the differences between the two situations and between the two entities being modelled.
- 6.218 We consider that if Ofcom were to adopt an approach to modelling BT Sports costs that more closely resembled the WMO model, it would be a more dynamic, DCF approach. Such an approach to BT Sport modelling would encounter the same difficulties as would arise if it were to be applied to the Margin Condition as a whole. Consequently, we refer here to the discussion of and conclusions drawn on reference questions 3(c), 4(a) and 5(a) in paragraphs 5.25 to 5.64 under the static approach. We also consider that to adopt an approach that more closely resembled the WMO model would assume that BT was continuing to incur start-up costs for BT Sport during the

⁴⁶³ DCF analysis is considered with reference questions 4(a) and 5(a); treatment of upfront costs and allowing for losses in the first years after entry are considered with reference questions 3(f) and 3(g); and the ACL adjustment is considered with reference question 3(d).

⁴⁶⁴ In its statement dated 19 November 2015, 'Review of the wholesale must-offer obligation'.

⁴⁶⁵ BT core submission, volume 2, paragraph 214.

review period. We therefore also rely on our assessment and conclusions on this point in addressing BT's reference question 3(g).

Our determination on reference questions 3(h), 4(h) and 5(c): the Pay TV approach

Reference question 3(h)

6.219 For the reasons set out in paragraphs 6.212 and 6.214 above, we determine that BT has not shown Ofcom to have been inconsistent by taking a different approach to modelling BT Sports costs from its approach when modelling the new entrant for the WMO obligation in Pay TV. We therefore determine on reference question 3(h) that Ofcom did not err in adopting an approach to BT's costs of entry that differs from the approach adopted by Ofcom in its Pay TV statement.

Reference question 4(h)

6.220 At its main party hearing, BT said of the point of discrimination raised in reference question 4(h) that it is 'essentially the same point about regulatory consistency'.⁴⁶⁶ This being the case, in line with our determination in relation to reference question 3(h), we determine that the regulatory condition imposed by Ofcom does not unduly discriminate against BT by comparison with the approach taken to Sky in respect of Pay TV, and as such Ofcom has not erred in respect of reference question 4(h).

Reference question 5(c)

6.221 Similarly, the alternative approach put forward in reference question 5(c) is a remedy for the errors alleged in reference questions 3(h) and 4(h). Since we have determined that Ofcom did not err in respect of reference questions 3(h) or 4(h), we determine for reference question 5(c) that Ofcom was not in breach of the principle of proportionality by not adopting the alternative approach as used in the Pay TV statement.

7. BT Appeal: Legal and regulatory principles

7.1 In this section we assess BT's arguments that Ofcom's approach in introducing the Margin Condition involved broad errors of principle and/or constituted breaches of EU and domestic law. This addresses reference

⁴⁶⁶ BT hearing transcript p125, line 26.

questions 1, 2 and those parts of reference question 4 which have not already been addressed in previous sections of this document.

7.2 We set out our assessment and determination on the following reference questions:

- (a) Objective justification and proportionality (reference question 4e).
- (b) Promotion of competition, efficiency or consumer benefits (reference question 4f).
- (c) Proper account of BT's investment (reference question 4g).
- (d) Utmost account of the views of the European Commission (reference question 1).
- (e) Legal certainty and transparency (reference questions 2 and 4(i)).

Reference question 4(e): Objective justification and proportionality

7.3 By reference question 4(e), BT alleged that Ofcom erred by imposing a regulatory condition on BT which was not objectively justified by, and was disproportionate to, Ofcom's stated regulatory aim in imposing that condition.

BT's case

7.4 BT argues that the collective impact of the flaws in design (as set out in its other reference questions), is that the Margin Condition is not an objectively justified or proportionate means of achieving Ofcom's stated regulatory aim.⁴⁶⁷

7.5 As set out in the first witness statement of James Tickel and the RBB report, BT states that the static model with a focus on the margin BT is making on a monthly basis on the cohort of acquired customers on a LRIC+ and adjusted EEO basis, does not reflect the realities of how its competitors would assess the incremental profitability of a SFBB customer. BT argues that the Margin Condition will overstate the margin those competitors require, limiting BT's pricing freedom and, in so doing, providing a 'margin umbrella' for those competitors.⁴⁶⁸

7.6 Therefore BT alleges that the Margin Condition is contrary to Article 8(4) of the Access Directive, sections 47(2)(a) and (c) and 88(1)(b) of the Act, and

⁴⁶⁷ BT AmNoA, paragraph 258.

⁴⁶⁸ BT AmNoA, paragraph 259.

the general principle of proportionality binding on Ofcom as a NRA under the CRF.

Our assessment of reference question 4(e): Objective justification and proportionality

- 7.7 In this reference question, BT draws generally on its arguments regarding the various flaws in design in order to allege that *collectively* these result in the test being neither objectively justified nor proportionate to Ofcom's stated regulatory aim. BT in particular refers to:
- (a) the static nature of the model;
 - (b) monthly margin;
 - (c) LRIC+; and
 - (d) adjusted EEO approach
- 7.8 BT has argued that as a result of these 'flaws', the test is contrary to various legal requirements binding Ofcom (see paragraph 7.6).
- 7.9 Ofcom's relevant statutory duties and legal framework are set out at a high level in Section 2 above. Section 7 of the Final Statement set out Ofcom's reasoning on why it considered the test to be appropriate and why it satisfied the various legal tests, drawing on its assessments in relation to each element of the remedy and specific methodology it adopted. Ofcom's assessment on objective justification and proportionality was set out in paragraphs 7.33 and 7.35 to 7.36 of its Final Statement where it concluded that it was satisfied that the Margin Condition was objectively justified and proportionate.
- 7.10 In its response to our provisional determination, BT stated that our provisional finding not to find an error in relation to this reference question was legally erroneous insofar as it was contrary to the logic of our own findings.⁴⁶⁹ BT's argument was that, if we have found one element of the Margin Condition to be disproportionate, then we were bound to find that the Margin Condition, as a whole, was in breach of the principle of proportionality, and that the CMA was wrong to reach an overall conclusion that seeks to isolate its findings as to the compliance period from the other aspects of the Margin Condition. In our view, approaching this reference question in this way would require us to ignore the specific grounds pleaded by BT in its Amended Notice of Appeal and which are incorporated into the reference question.

⁴⁶⁹ BT response to our provisional determination, paragraph 9.

- 7.11 We have already considered each of the alleged errors referred to by BT in this reference question on an individual basis.⁴⁷⁰ We have determined that Ofcom did not err in relation to the static nature of the model, the use of a LRIC+ test or its use of an adjusted EEO approach, but has erred with respect to the imposition of a one-month compliance period and that in this regard, and in this regard alone, the Margin Condition is disproportionate.
- 7.12 In coming to our determination in relation to this reference question, we have taken into account the fact that BT's argument is that, as a result of the collective impact of the alleged flaws in design identified by BT, the Margin Condition is not an objectively justified or proportionate means of achieving Ofcom's regulatory aim. We have, however, found that only one element in the design of the Margin Condition – ie the imposition of a one-month compliance period – is disproportionate to Ofcom's regulatory aim. We have not found any additional flaws in the design of the model and as a result there is no collective impact rendering the Margin Condition as a whole disproportionate to Ofcom's regulatory aim. As noted in relation to reference question 5(d) (see paragraph 4.71), we consider that, when a more appropriate compliance period has been substituted for the one-month compliance period, the Margin Condition will be objectively justified and proportionate to Ofcom's regulatory aim.

Our determination on reference question 4(e): Objective justification and proportionality

- 7.13 For the reasons given above, we determine that the collective effect of the design elements of the Condition was objectively justified by, and proportionate to, Ofcom's regulatory aim. We therefore conclude that Ofcom did not err in respect of reference question 4(e).

Reference question 4(f): Promotion of competition, efficiency or consumer benefits

- 7.14 By reference question 4(f), BT alleged that Ofcom erred in imposing a regulatory condition on BT that BT alleged failed to: promote efficiency; promote sustainable competition; and/or confer the greatest possible benefits on consumers.

⁴⁷⁰ We consider BT's arguments on the static approach in Section 5, and its arguments on monthly, LRIC+ and adjusted EEO in Section 4.

BT's case

- 7.15 BT argues that 'as a result of imposing a regulatory control which goes beyond its stated aim, Ofcom's approach not only fails to promote but actually restricts and/or distorts competition in SFBB and bundles including SFBB'.⁴⁷¹ BT states that this weakens effective retail price competition and decreases current and future incentives to invest in innovations that drive consumer surplus.
- 7.16 In support of this point BT cites Section 6 of the RBB report which sets out how inappropriate regulatory interventions are likely to give rise to adverse effects on dynamic efficiency via the impact of the proposed regulatory intervention on the incentives of firms to invest in SFBB.⁴⁷²
- 7.17 BT refers to the effect of Ofcom's treatment of BT Sport as a particularly acute example of the perverse consequences of Ofcom's approach, hindering BT's ability to compete in a number of ways. In particular, BT states this is because:
- (a) it increases the incentive of BT's rivals to exploit the different valuations that customers purchasing BT bundles will have of the different products and thereby to force BT to increase the price of its bundles;
 - (b) it hampers BT's ability to monetise assets with variable pay-offs, restricting the options available to BT to recover its investments in profitable sports rights;
 - (c) it restricts BT's ability to compete in markets for sports rights; and
 - (d) it distorts incentives for BT to make risky investments.⁴⁷³
- 7.18 BT therefore states that Ofcom has erred in its application of the legal and economic principles relevant to the design of an SMP condition and in particular section 88(1)(b) of the Act.⁴⁷⁴

Our assessment of reference question 4(f): Promotion of competition, efficiency or consumer benefits

- 7.19 BT's arguments in relation to this reference question are broad in nature and build on its points in reference question 4(e) and arguments it makes in other reference questions regarding the perverse consequences of the Margin

⁴⁷¹ BT AmNoA, paragraph 261.

⁴⁷² RBB report, paragraphs 188–192.

⁴⁷³ BT AmNoA, paragraph 262.

⁴⁷⁴ BT AmNoA, paragraph 263.

Condition. In essence we understand BT to be arguing that because of the alleged flaws in the design of the control, in particular as regards its treatment of BT Sport, the Margin Condition is ineffective, such that it actually restricts/distorts competition in SFBB, weakens price competition and decreases incentives for CPs to invest.

- 7.20 Section 88(1) of the Act provides that Ofcom is not to set a SMP condition falling within section 87(9) except where it appears to Ofcom from the market analysis carried out for the purpose of setting that condition that there is a relevant risk of adverse effects arising from price distortion, and it also appears to Ofcom that the setting of the condition is appropriate for the purposes of:
- (a) promoting efficiency;
 - (b) promoting sustainable competition; and
 - (c) conferring the greatest possible benefits on the end-users of public electronic communications services.
- 7.21 Ofcom sets out its reasoning as to why it considers the Margin Condition as designed is appropriate for the purposes above, in paragraphs 7.9 to 7.23 of the Final Statement, and addresses each of these required tests. In particular, Ofcom states that it has struck a reasonable balance between losses of static efficiency on the one hand, and gains from dynamic efficiency on the other; that the Margin Condition will ensure that BT cannot use its SMP to set the VULA margin such that it causes retail competition in superfast broadband to be distorted; and that the condition will thereby act as a driver for greater choice, lower prices and product innovation.
- 7.22 In its pleadings BT raises a number of specific arguments as regards the perverse consequences of Ofcom's approach in relation to BT Sport, which we have assessed in Section 6 above on BT Sport and which we did not uphold. Therefore we have not considered these arguments further here.
- 7.23 BT also refers broadly to the conceptual arguments set out in Section 6 of the RBB report which relate to investment incentives as regards TV rights. We consider investment incentives in relation to reference question 4(g) below regarding BT's investment, and we have not found that Ofcom erred. We do not consider that BT has raised any substantive additional issues beyond the conceptual concerns raised in Section 6 of the RBB report which relate to Ground 1 and have been decided by the CAT.
- 7.24 Given this, and the fact that in reference question 4(e) we have not found that Ofcom erred in imposing a test which went beyond its regulatory aim, nor

were we persuaded on BT's specific points on perverse effects in relation to sport, we have concluded that BT has not shown that the Margin Condition restricts or distorts competition.

Our determination on reference question 4(f): Promotion of competition, efficiency or consumer benefits

7.25 Taking into account, our findings in other parts of our determination (in particular those in Section 6 on perverse effects and below in reference question 4(g)), we consider that BT has not demonstrated that Ofcom has erred in respect of this reference question. More specifically, we determine that Ofcom did not impose a regulatory condition on BT that fails to:

- (a) promote efficiency;
- (b) promote sustainable competition; and/or
- (c) confer the greatest possible benefits on consumers.

Reference question 4(g): BT's investment

7.26 By reference question 4(g), BT alleged that Ofcom erred in its treatment of BT's investment in the matters to which the Price Control relates and, in particular, its investment in its fibre NGA network and in acquiring sports content.

Ofcom's approach

7.27 In general, Ofcom concluded that a margin control was unlikely to have a material impact on BT's investment incentives or those of other providers. It stated that a margin regulation was equivalent to a 'retail minus' control on the wholesale price whereby the regulated firm retains the flexibility to set whatever level of wholesale prices it wishes, provided that its retail price is suitably above the wholesale price. As a result Ofcom concluded that the Margin Condition should 'protect retail competition while still allowing BT to earn an appropriate return at the wholesale level, in particular an apparently high return may be appropriate where it is the upside of a risky investment.'⁴⁷⁵

7.28 Ofcom's consideration of BT's investment in sports rights and our assessment of BT's arguments in that respect are set out in Section 6 above on BT Sport. In relation to BT's investments in NGA, Pay TV and other CPs, Ofcom

⁴⁷⁵ [Final Statement](#), paragraphs 7.29, 3.121 & 4.27.

concluded it was unlikely to have a significant adverse impact for the reasons summarised below.⁴⁷⁶

7.29 In relation to BT's NGA investment incentives, Ofcom stated that:

- (a) the small adjustments (beyond EEO) to the VULA margin likely to be required suggested any reduction to the VULA charge would be limited;
- (b) its underlying approach was consistent with the previous regime and there had been a high level of investment under that regime; and
- (c) its approach ensured certainty whilst retaining appropriate flexibility to adjust to significant changes that might occur.⁴⁷⁷

7.30 In relation to Pay TV, Ofcom explained that the Margin Condition would have limited impact on BT's incentives on Pay TV because:

- (a) it still allowed considerable flexibility over BT's cost recovery, in particular it can set different margins on SFBB services;
- (b) it provides further flexibility if there are material changes of circumstance;
- (c) BT currently appears to have sufficient margin to fully absorb the costs of BT Sport;
- (d) as BT becomes a more established Pay TV operator it is less likely to need to defer the recovery of sports rights costs into the future; and
- (e) in any event, the limited impact is balanced against the importance of preventing a distortion to competition in SFBB.⁴⁷⁸

BT's case

7.31 BT considers that Ofcom's approach fails to take proper account of the investment made and risk incurred by BT in the matters to which the Margin Condition relates. It refers in particular to two aspects:

- (a) BT's significant investment in the £2.5 billion fibre roll-out.
- (b) BT's substantial investment in the acquisition of sports rights.⁴⁷⁹

⁴⁷⁶ Ofcom defence (BT Appeal), paragraphs 559–564.

⁴⁷⁷ [Final Statement](#), paragraphs 3.120–3.121, 4.62 & 4.65.

⁴⁷⁸ [Final Statement](#), paragraphs 6.298 & 7.62–7.67

⁴⁷⁹ BT AmNoA, paragraph 264: Witness statement of John Petter, paragraphs 14 & 46–58.

- 7.32 BT states that Ofcom's assessment was 'manifestly inadequate to meet its statutory duties to promote innovation and investment, and its reasoning was fundamentally flawed'.⁴⁸⁰ It goes on to argue that Ofcom failed to recognise the 'serious implications of imposing a poorly designed margin control' and cites, in support, Sections 4 and 6 of the RBB report.⁴⁸¹
- 7.33 On its incentives in Pay TV, BT rejects Ofcom's position in the Final Statement that the Margin Condition will have limited impact on BT's incentives to bid for future rights *inter alia* because BT is a 'more established Pay TV operator'.⁴⁸² BT refers to the arguments set out in the RBB report at Section 5 which it says 'expose the perverse consequences of the inclusion of the net costs of BT Sport within Ofcom's margin squeeze test'.⁴⁸³
- 7.34 BT alleges that these failings constitute further errors of the statutory principles governing the exercise of Ofcom's statutory powers. These are to take account of BT's relevant investments, to encourage investment and innovation and to ensure that the Condition is appropriate for the purpose of promoting efficiency.⁴⁸⁴

Our assessment of reference question 4(g): BT's investment

- 7.35 At its main party hearing, BT clarified that reference question 4(g) makes two points: the first is that the cumulative effect of the other alleged errors affects BT's investment incentives; and second, that in so doing, Ofcom has breached a separate statutory requirement.⁴⁸⁵
- 7.36 We have considered the points made in Section 4 of the RBB report on Ofcom's use of a LRIC+ approach which it argues creates a 'price umbrella'; the monthly test; and the adjusted EEO approach and ACL. Although we have determined that Ofcom erred on the monthly test, we do not consider that this error is such that, as BT alleges, the Margin Condition was poorly designed creating 'serious implications' for BT's investment incentives. We have determined that Ofcom did not err on LRIC+ or ACL. Therefore, our findings on the design of the test, and BT's other alleged errors, do not support BT's assertion that the regulation as whole is inappropriate nor that there are cumulative errors which would affect investment incentives.

⁴⁸⁰ BT AmNoA paragraph 265.

⁴⁸¹ RBB report, Sections 4 & 6.

⁴⁸² BT AmNoA, paragraph 7.65.

⁴⁸³ BT AmNoA paragraph 265.

⁴⁸⁴ BT references various parts of the Act under s.88(2), s3(4)(b) and (d) and s.88(1)(b)(i) respectively.

⁴⁸⁵ BT hearing transcript, p103.

- 7.37 We have separately considered and dismissed BT's arguments on perverse consequences as a result of BT Sport (see paragraphs 6.71 to 6.72 in Section 6). In relation to BT's concerns on investment in fibre, its case here essentially relies on very similar arguments to those advanced on sport investment.
- 7.38 Section 6 of the RBB report states that BT may be disincentivised from investing in any future improvements to its fibre network⁴⁸⁶ and that rivals will have a reduced incentive to invest in alternative networks due to the 'subsidy that the VULA margin condition gives them'.⁴⁸⁷
- 7.39 As set out in paragraphs 7.24 to 7.31 of the Final Statement, and summarised above in paragraphs 7.29 to 7.30, Ofcom took account of the potential effect on BT's investment incentives. We do not agree that this assessment is 'manifestly inadequate to meet its statutory objectives', as BT alleges. Further, taking into account that we have not upheld the majority of BT's alleged errors relating to the design of the test, we do not agree with the points made in Section 6 of the RBB report that Ofcom's regulatory intervention was inappropriate.⁴⁸⁸

Our determination on reference question 4(g): BT's investment

- 7.40 Based on our assessment set out above and on related reference questions, we have determined that Ofcom did not err in its treatment of BT's investment in the matters to which the Price Control relates.

Reference question 1: Utmost Account

- 7.41 By reference question 1, we are required to determine whether Ofcom erred by failing to take 'utmost account' of the views of the Commission, for the reasons set out in paragraphs 106 to 134 of BT's Amended Notice of Appeal.
- 7.42 BT claims that Ofcom failed to take 'utmost account' of the Commission's views on Ofcom's proposed decision on the Margin Condition as set out in the 2013 Recommendation, the Commission's Recommendation on relevant product and service markets within the electronic communications sector susceptible to ex ante regulation in accordance with Directive 2002/21/EC of the European Parliament and of the Council on a common regulatory framework for electronic communications networks and services ('the 2014 Recommendation') and the Commission's Comments. BT says this is contrary

⁴⁸⁶ RBB report, paragraph 193.

⁴⁸⁷ RBB report, paragraph 194.

⁴⁸⁸ [Final Statement](#), paragraph 3.119.

to Ofcom's statutory obligations, as set out by sections 4A, 48A, 48B and 79 of the Act, which give effect to Articles 7(2), 7(7), 15(3) and 19(2) of the Framework Directive.⁴⁸⁹

Legal framework

7.43 The Framework Directive is one of the directives which establish a harmonised framework for the regulation of electronic communications services and networks and a set of procedures to ensure the harmonised application of the regulatory framework throughout the Community.

7.44 The provisions relied on by BT are:

- (a) NRAs must work with the Commission and BEREC to identify the types of instruments and remedies best suited to address particular types of situations in the marketplace;⁴⁹⁰
- (b) the NRA may adopt the draft measure, after taking 'utmost account' of any comments made by the Commission, BEREC or any other NRA;⁴⁹¹
- (c) NRAs must, taking the utmost account of the Recommendation and the Guidelines of the Commission, define relevant markets appropriate to national circumstances, in accordance with the principles of competition law;⁴⁹² and
- (d) where the Commission issues recommendations to member states, NRAs must take 'utmost account' of those recommendations in carrying out their tasks. Where a NRA chooses not to follow a recommendation, it must inform the Commission, giving its reasons for not doing so.⁴⁹³

7.45 The obligation to take 'utmost account' is given force in the UK by section 4A of the Act, which requires Ofcom to take 'due account' of all applicable recommendations issued by the Commission under Article 19(1) of the Framework Directive. However, both Ofcom and BT are in agreement that Ofcom's duties under the Act must be construed in a way consistent with the Framework Directive, ie that Ofcom is obliged to take 'utmost account' of the Commission's views.

⁴⁸⁹ BT AmNoA, paragraph 106.

⁴⁹⁰ Article 7.2.

⁴⁹¹ Article 7.7.

⁴⁹² Article 15.3.

⁴⁹³ Article 19.2.

Background

- 7.46 In September 2013, the Commission issued the 2013 Recommendation, in accordance with the procedure set out in the Framework Directive. In broad terms, the Commission recommended methodologies for assessing the costs which incumbents may charge for giving others access to their copper networks and for ensuring that there is equivalent access to networks.
- 7.47 BT also refers to the 2014 Recommendation. BT has, however, made no further mention of the 2014 Recommendation with regard to reference question 1, and does not appear to be relying on the 2014 Recommendation in its arguments relevant to reference question 1.
- 7.48 Ofcom consulted interested parties on its proposed Margin Condition, and on 15 January 2015, notified the Commission, BEREC and other NRAs of its proposed decision. The Commission reviewed Ofcom's draft decision⁴⁹⁴ and responded with its comments to Ofcom in a letter of 13 February 2015.⁴⁹⁵ Ofcom did not receive any comments, however, from BEREC or from any NRA.
- 7.49 The Commission's Comments were directed to some inconsistencies between the 2013 Recommendation and Ofcom's proposed Margin Condition. The Commission:
- (a) noted that BT might be able to impose a price squeeze and, thus, distort competition for superfast broadband;
 - (b) recognised the potential importance of bundled offers for the health of retail competition for SFBB, leading to Ofcom considering it appropriate to include, in principle, all bundled elements, in particular the provision of BT Sport, in the calculation of the economic replicability test (ERT); and
 - (c) took note of the evidence provided by Ofcom that BT's investment in BT Sport was part of BT's strategy to, at the very least, retain its current broadband customer base (if not to increase it actively).
- 7.50 However, the Commission considered the following:
- (a) The considerable costs paid by BT for premium content rights is a long-term investment in a market where BT does not have SMP, where the

⁴⁹⁴ Prior to issuing its Comments, the Commission requested information from Ofcom on 27 January and Ofcom responded on 30 January 2015.

⁴⁹⁵ This letter was sent pursuant to Article 7(3) of the Framework Directive.

regulatory framework on which the SMP measure is based does not apply and in which BT faces strong competition.

- (b) Using a static, period-by-period approach, which looks at a short time interval (six months) in isolation would unduly limited BT's flexibility to defer the recovery of its costs for BT Sport over a longer period.
- (c) Annex II to the 2013 Recommendation states that NRAs should evaluate the profitability of the relevant retail products on the basis of a dynamic multi-period analysis (such as a DCF approach) and that an adequate reference period would be the ACL. The 2013 Recommendation stated that the ability to recover relevant costs should be assessed over the entire period, allowing flexibility to defer recovery towards the end of the ACL, with the result that a low margin could be permissible at the beginning of the ACL.
- (d) The 2013 Recommendation also indicated that NRAs should annualise the downstream costs according to an appropriate depreciation method that takes account of the economic lifetime of the relevant assets (which can be longer than the ACL). The Commission considered that following the recommended LRIC+ methodology combined with a DCF approach should give additional flexibility to defer the recovery of a proportion of the relevant downstream costs to a period where expected demand is higher. It considered that such a flexible approach was important to allow the SMP operator to build sufficient scale.

7.51 In light of the above, the Commission considered that Ofcom's proposed approach lacked the necessary flexibility, in particular with regard to the treatment of BT Sport.⁴⁹⁶

7.52 Moreover, the Commission considered there was a risk that Ofcom's regulatory activity would have a significant impact on related non-regulated markets, without necessarily affecting the price of the VULA input, so that 'Ofcom will therefore have to remain vigilant that the application of the test does not have unintended consequences in markets where the application of *ex post* competition law would be sufficient, or where BT's SMP in the WLA market does not necessarily play a role'.

7.53 The Commission invited Ofcom to revisit the decision of the proposed ERT in its final measure and to ensure that sufficient flexibility was given to BT to recover the considerable costs for BT Sport over a longer time horizon. Finally, the Commission indicated that it would, together with Ofcom, monitor

⁴⁹⁶ Commission letter to Ofcom (13 February 2015).

the situation with regard to the consequences of the application of the test, particularly in respect of the appropriateness of the responses in the event that the test is not passed.

- 7.54 The Commission did not, however, use its powers under Article 7a(1) Framework Directive to require a three month delay before the Margin Condition could be adopted. Ofcom therefore published its Final Statement on 19 March 2015, which included its reasons for not following the Commission's views.

BT's case

- 7.55 BT claims that Ofcom failed to take 'utmost account' of the 2013 and 2014 Recommendations, the Commission's Comments and the 2012 opinion of BEREC.
- 7.56 In particular, BT claims that Ofcom failed to take utmost account of the Commission's specific criticisms of the Margin Condition as to the relevant time period for assessing profitability and the recovery of costs and the relevant cost standard, and of the opinion of BEREC as to the 'bright-line' test.
- 7.57 BT claims that Ofcom failed to take account of the Commission's view that 'static period-by-period approach looking at a short time interval (six months) in isolation, unduly limits BT's flexibility to defer the recovery of its costs for BT Sport over a longer) period.'
- 7.58 BT noted that in the Commission's Comments, the Commission stressed that Ofcom's approach did not conform with the 2013 Recommendation that NRAs should evaluate profitability using a dynamic multi-period analysis with the ability to recover relevant costs over the entire ACL period and the flexibility to defer recovery towards the end of the ACL (ie so a low margin could be permissible at the beginning of the ACL). In addition, BT explained that the Commission's view was that Ofcom's static test 'lacked the necessary flexibility' as regards the treatment of costs for BT Sport, and unduly limited BT's commercial activity as regards the Pay TV markets in which BT does not have SMP.
- 7.59 BT further submits that whereas the Commission had requested Ofcom 'to revisit the design' of its proposed test in its Final Statement to ensure that 'sufficient flexibility' was given to BT to recover the 'considerable costs' of BT Sport over 'a longer time horizon', Ofcom has applied the Margin Condition on a shorter time basis – ie a monthly assessment, not a six-monthly assessment.

- 7.60 BT states that the Final Statement also rejected any forward-looking analysis of the kind recommended by the European Commission, and contrary to Annex II to the 2013 Recommendation, adopted an adjusted EEO cost standard rather than a EEO standard (which would have estimated costs on the basis of the SMP operator's own downstream business).
- 7.61 In addition, BT states that by imposing a 'bright line' pass/fail test based solely on an accounting exercise and without reference to the reasons for and/or the effects of any failure, Ofcom failed to take utmost account of the opinion of BEREC that such tests 'as determinants of a margin squeeze taking place may not always be suitable' in the case of bundles.

Our assessment of reference question 1: Utmost account

- 7.62 We consider, and the parties agree, that Member States have an obligation to achieve the result envisaged by a directive,⁴⁹⁷ and a duty to take all appropriate measures, whether general or particular, to ensure the fulfilment of that obligation.⁴⁹⁸ It is, therefore, common ground that before adopting the Margin Condition, Ofcom had a duty under to take utmost account of the 2013 Recommendation⁴⁹⁹ and of the Commission's Comments of February 2015.⁵⁰⁰
- 7.63 We note, however, that under the TFEU, recommendations and opinions have no binding force and do not confer any rights or obligations on those to whom they are addressed,⁵⁰¹ so that Ofcom did not have a duty to comply with the views of the Commission, and could depart from them, so long as it could show that it had carefully reviewed the Commission's Recommendation and Comments before doing so.
- 7.64 We consider that our view is consistent with the judgment in the *Vodafone España* case,⁵⁰² which was cited both by BT and by Ofcom. The Court said in that judgment, as regards the effect of a Commission letter issued pursuant to Article 7.3 of the Framework Directive, that:

[93] ... it must be noted that the legal effects of a letter under Article 7.3 of [the Framework Directive] are clearly set out at Article 7.5, according to which the notifying NRA shall take the utmost account of comments of other [NRAs] and the Commission. That wording underlines the non-binding nature of a

⁴⁹⁷ Case 14/83 *Von Coulon and Kaman v Land Nordrhein-Westfalen* [1984] ECR 1891, at [26]; Case C-106/89 *Marleasing* [1990] ECR I-4135, at [8].

⁴⁹⁸ Article 4(3), TFEU.

⁴⁹⁹ Article 19(2) Framework Directive.

⁵⁰⁰ Article 7(3) Framework Directive.

⁵⁰¹ Article 288, TFEU.

⁵⁰² Case T-109/06 *Vodafone España v Commission* [2007] ECR II-5151.

Commission letter under Article 7.3 of [the Framework Directive]. Article 7.5 of the [the Framework Directive] does not, therefore, provide that the Commission's comments are to prevail over those of other NRAs. ... Accordingly, in a case where the comments of an NRA and of the Commission are contradictory, the notifying NRA would not infringe Article 7.5 of [the Framework Directive] by following, after careful review of the various comments, the approach proposed by the other NRA and not that proposed by the Commission.

- 7.65 We note that in its Final Statement Ofcom addressed extensively the 2013 Recommendation,⁵⁰³ the Commission's Comments,⁵⁰⁴ and the BEREC Common Position and Guidance.⁵⁰⁵
- 7.66 We further note, as Ofcom points out, that the Commission did not exercise its power under Article 7a of the Framework Directive to notify Ofcom that the draft measure would create a barrier to the single market, or that the Commission had serious doubts as to the compatibility of the measure with Community law, causing adoption of the draft measure to be suspended for three months.
- 7.67 We have therefore considered whether we can be satisfied from the reasons given in the relevant paragraphs of the Final Statement that Ofcom did carefully review, and take utmost account of, the Commission's views before making its Final Statement.
- 7.68 We have given detailed consideration in the other reference questions to some specific issues arising from differences between Ofcom's approach and the approach set out in the 2013 Recommendation and the Commission's Comments. We note that we have not found that Ofcom erred in any areas in which BT has argued the Commission was advocating an alternative approach and, where we have identified an error, we do not consider that the Commission's comments were relevant. However, for the purposes of this reference question we have considered whether, as Ofcom was not under a duty to comply with the views of the Commission, the evidence shows that Ofcom addressed the relevant views of the Commission and BEREC and gave them careful review before taking its final decision. We are satisfied that it does. Where Ofcom has departed from those views, we are satisfied that it had clear and cogent reasons for doing so.

⁵⁰³ [Final Statement](#), paragraphs 7.94–7.125.

⁵⁰⁴ [Final Statement](#), paragraphs 7.137–7.157.

⁵⁰⁵ [Final Statement](#), paragraphs 7.126–7.136.

Our determination on reference question 1: Utmost account

7.69 In relation to reference question 1, we determine that Ofcom has not erred by failing to take utmost account of the views of the Commission.

Reference questions 2 and 4(i): Legal certainty and transparency

Introduction

7.70 The focus of reference questions 2 and 4(i) is BT's complaint that the Final Statement lacks clarity in relation to its treatment of material changes in circumstances. In particular, BT argues that, whilst Ofcom has included some flexibility in the Final Statement, it has provided no clarity as to what the scope of that flexibility may be.

7.71 In relation to reference question 2, BT argues that Ofcom erred by failing to comply with the general principles of EU law and, in particular, with the principle of legal certainty. BT asserts that it is unclear from the Final Statement when Ofcom will consider there to have been a material change in circumstance to justify a departure from the Margin Condition, and how Ofcom will vary the application of the Margin Condition, if such a material change in circumstance is found.

7.72 In relation to reference question 4(i), BT argues that Ofcom erred in imposing a regulatory condition on BT that BT alleges fails to provide the requisite transparency in relation to what it is intended to achieve. BT asserts that the design of the Final Statement breaches the statutory test under the section 47 of the Act in this regard.

7.73 In this section, we first consider Ofcom's approach to material changes in circumstances as contained in the Final Statement (and the Supplementary Guidance), before summarising BT's arguments in respect of each reference question. We then set out our assessment and determination of the two reference questions.

Ofcom's approach

7.74 It is clear from the Final Statement that Ofcom considered that there may be times when a departure from the general approach set out in the Final Statement is required.

7.75 If, for example, there is a material change in circumstances, Ofcom accepts that it will need to take account of this in any future assessment. Whether or not it will be appropriate to depart from its general approach will depend on

the specific circumstances of any such change. Ofcom did not consider it could give guidance on every possible eventuality, but explained that there may be certain circumstances which might require it to adapt its approach to assessing the VULA margin.⁵⁰⁶

7.76 In this regard, Ofcom notes that, if BT were to add an extra feature or product to its superfast broadband bundles, this will result in a number of extra costs for BT in the first month in which it is added. However, during that first month, volumes may be low and, as a result, were the VULA margin assessment conducted using data relating to the first month only, then BT's estimated margin may be too low. In contrast, BT's margin may be sufficient when compliance is assessed in further months, once the volumes associated with that extra feature have increased.⁵⁰⁷

7.77 Ofcom therefore recognises that, where there is a material change in circumstances (such as a significant change to BT's business model for superfast broadband), rigidly applying the approach set out in the Margin Condition in each compliance period could lead to the problems described above.⁵⁰⁸

7.78 At paragraph 6.25 of the Final Statement, Ofcom states as follows:

Having considered these issues further, particularly in light of the European Commission's comments, we have provided additional details on how we may respond flexibly to a material change in circumstance. When conducting an assessment, we would consider whether a material change in circumstances occurred shortly before or during the compliance period. If this was the case then we may take increases in future demand into account. Depending on the specific circumstances, we may consider whether the cost and revenue data used in the compliance assessment is representative of the margin over the ACL.

7.79 Ofcom then sets out 'one possible approach' it may follow in circumstances where it is appropriate to place more weight on BT's ability to build scale.⁵⁰⁹

7.80 Ofcom notes, however, that it may need to adopt a different approach where it considers that a material change in circumstances has taken place and any

⁵⁰⁶ [Final Statement](#), paragraph 6.5.

⁵⁰⁷ [Final Statement](#), paragraph 6.23.

⁵⁰⁸ [Final Statement](#), paragraph 6.24.

⁵⁰⁹ [Final Statement](#), paragraph 6.25.

subsequent growth in demand that has been observed is not reasonably representative of the margin over the ACL.⁵¹⁰

- 7.81 Finally, Ofcom explains that allowing itself flexibility to adopt a different approach strikes a balance between the benefits of assuming a constant margin based on historic data and the limitations that can arise in some circumstances.⁵¹¹
- 7.82 In the course of the consultation on the Supplementary Guidance, BT requested further clarification about how the Margin Condition will be assessed in light of other material changes in circumstances. Ofcom reiterated in the Supplementary Guidance that it did not think it would be appropriate, nor in many cases possible, to provide in advance detailed guidance on its approach in every possible eventuality.⁵¹² Further, Ofcom explained that it did not consider that it could provide additional guidance as to the approach it would be likely to adopt as it would need to consider any material changes of circumstances on a case-by-case basis.⁵¹³

BT's case

Reference question 2

- 7.83 In relation to reference question 2, BT argues that legal certainty is a fundamental principle under EU law, which aims to ensure respect for regulatory stability and predictability and, thus, recognises the importance of forward-planning for individuals and market players.⁵¹⁴
- 7.84 BT asserts that the Final Statement and associated guidance are wholly lacking in the clarity and certainty that would be needed for BT to 'ascertain unequivocally what its rights and obligations are and take steps accordingly' or to 'establish precisely their legal position'.⁵¹⁵
- 7.85 BT argues that the uncertainty relates to the provisions in the Final Statement which relate to material changes in circumstances.
- 7.86 Whilst recognising some flexibility may be permitted by Ofcom in the application of the Margin Condition, BT asserts that Ofcom has provided no clarity as to what the scope of that flexibility may be, and criticises Ofcom's

⁵¹⁰ [Final Statement](#), paragraph 6.25A.

⁵¹¹ [Final Statement](#), paragraph 6.26.

⁵¹² [Supplementary Guidance](#), paragraph 2.68.

⁵¹³ [Supplementary Guidance](#), paragraph 2.68.

⁵¹⁴ BT AmNoA, paragraph 137.

⁵¹⁵ BT AmNoA, paragraph 143.

language at paragraph 6.25 of the Final Statement (which relates to material changes in circumstances) as being ‘so vague and non-specific as to provide no effective guidance’. BT claims that the guidance is ‘fundamentally unclear and lacking transparency as to both (i) what will, in fact, be considered to be a material change in circumstances, and (ii) what the response of Ofcom would, in fact, be if such a change occurs’.⁵¹⁶ BT asserts that it is, therefore, ‘impossible for BT to know what actual standard would be applied by Ofcom in such a case or to plan its business by reference to that standard’.⁵¹⁷

7.87 BT then sets out a number of specific criticisms made of Ofcom’s approach to the launch of its UEFA content.⁵¹⁸

7.88 BT refers in this regard to the first witness statement of James Tickel, and argues that, far from resolving the inherent uncertainty in the Final Statement, the uncertainty of Ofcom’s approach has been demonstrated, and yet further compounded, by Ofcom’s response to BT’s request for clarification as to whether the launch costs of BT’s UEFA content would be considered a material change in circumstances.⁵¹⁹

7.89 In particular, BT asserts that Ofcom’s letter of 21 April 2015, which responded to BT’s request for clarification, did not provide any clear guidance as to the meaning of the Final Statement.⁵²⁰

7.90 BT goes on to set out its particular complaints in relation to legal certainty, namely:

(a) the letter was unclear on what Ofcom meant by ‘defer a decision on the outcome’,⁵²¹

(b) the proposed approach was effectively retrospective in its application,⁵²² and

(c) the effect of the approach adopted by Ofcom is that there is no clarity within the Margin Condition or associated guidance such as to allow BT to make strategic decisions or to ensure that it remains compliant on a firm regulatory basis.⁵²³

⁵¹⁶ BT AmNoA, paragraph 147.

⁵¹⁷ BT AmNoA, paragraph 147.

⁵¹⁸ BT AmNoA, paragraphs 148–157.

⁵¹⁹ BT AmNoA, paragraph 148.

⁵²⁰ BT AmNoA, paragraph 149.

⁵²¹ BT AmNoA, paragraph 150.

⁵²² BT AmNoA, paragraph 151.

⁵²³ BT AmNoA, paragraph 153.

- 7.91 BT further argues that Ofcom's decision to consult on how it intended to enforce the Margin Condition in light of the UEFA channel launch left the regulatory position in a highly unsatisfactory state and confirms that the procedure originally adopted following the Commission's Comments was unsatisfactory.⁵²⁴
- 7.92 Finally, in relation to the Supplementary Guidance, although BT welcomes the relaxation of the Margin Condition to the extent that it allows a degree of flexibility in the recovery of BT's UEFA content in its first year, it maintains its case that the Final Statement infringes the principle of legal certainty.⁵²⁵

Reference question 4(i)

- 7.93 In relation to reference question 4(i), BT alleges that the Margin Condition is contrary to the statutory principles applicable to all SMP conditions in that it fails to provide the requisite transparency in relation to what it is intended to achieve.⁵²⁶
- 7.94 BT argues that, despite Ofcom's repeated emphasis on the purported advantages to BT and other CPs of a condition which supposedly prioritises legal certainty over nuanced analysis of whether BT's conduct has had or is likely to have any adverse effect on competition or consumers, the Margin Condition and related guidance fail to provide BT with any certainty as to whether BT's investment in Sport will be treated in a commercially realistic manner.⁵²⁷ BT argues that this failure constitutes a breach of Ofcom's duty under the general principles of EU law and the specific requirement of section 47(2)(d) of the Act.

Our assessment of reference questions 2 and 4(i): Legal certainty and transparency

Reference question 2

- 7.95 We have considered the arguments raised by both BT and Ofcom in relation to reference question 2.
- 7.96 At the outset, we make the following preliminary observations.

⁵²⁴ BT AmNoA, paragraph 157(1). Whilst BT reserved its position here to argue that the approach that Ofcom ultimately adopted was and remains procedurally unfair as a matter of UK and/or EU law, it did not amend its Notice of Appeal to make this point further and, as such, this point does not need to be determined in this appeal.

⁵²⁵ BT AmNoA, paragraph 159.

⁵²⁶ BT AmNoA, paragraph 257(i). In support of this argument, BT relies on the Witness statement of John Petter.

⁵²⁷ BT AmNoA, paragraph 269.

- 7.97 First, we note that the focus of this reference question is BT's argument that Ofcom failed to comply with the general principles of EU law in relation to its treatment of material changes in circumstances within the Margin Condition. We understand BT's argument to be that the provisions in the Final Statement relating to material changes in circumstances provide no legal certainty to BT as to (i) when Ofcom will consider there to have been a material change in circumstance, and (ii) how Ofcom will vary the application of the condition, if such a material change in circumstance is found.
- 7.98 Second, we note that the parties are in agreement as to the legal test, in that the Margin Condition must satisfy the requirements of legal certainty and transparency, and agree that the Margin Condition must be sufficiently clear and precise so that individuals may know what their rights and obligations are in order to take steps accordingly.⁵²⁸
- 7.99 Third, we note that BT, both in its Amended Notice of Appeal and Core Submission Volume 2, accepts that (i) a certain degree of flexibility may be permitted in the application of the test, and (ii) there is a balance to be struck between responding flexibly to new circumstances on the one hand and the desirability for precision on the other.⁵²⁹
- 7.100 BT's principal argument in relation to this reference question is that the language used by Ofcom in paragraph 6.25 of the Final Statement is vague, non-specific and conditional in respect of (i) what may amount to (or trigger) a material change in circumstance on a case-by-case basis, and (ii) how Ofcom might amend the test to reflect such a change.
- 7.101 BT submits that, having regard to paragraph 6.25 of the Final Statement, it would appear that Ofcom has not yet decided on the appropriate approach. BT therefore asserts that it is impossible for it to know what actual standard will be applied by Ofcom or to plan its business by reference to that standard, so that, whenever BT is considering a major investment, it does not have any certainty because it simply does not know when such an investment will be treated as 'exceptional' and, if it is, what Ofcom will do to vary the Condition.⁵³⁰
- 7.102 Accordingly, BT asserts that it will face difficulties as to how the guidance will be interpreted at times when it is faced with key commercial decisions

⁵²⁸ Ofcom defence (BT Appeal), paragraph 248; BT core submission, volume 2, paragraph 83.

⁵²⁹ BT AmNoA, paragraph 147; BT core submission, volume 2, paragraph 84.

⁵³⁰ BT hearing transcript, p142.

involving the investment of very substantial sums of money and commercial risk.⁵³¹

- 7.103 We address this argument first before dealing with the additional complaints raised by BT in its pleadings.
- 7.104 In the first instance, we note that Ofcom contends that the question to be determined under this reference question is whether the guidance on material changes in circumstances in the Final Statement is sufficiently clear and precise, and not whether Ofcom has addressed every conceivable event.⁵³² We agree with this. We also agree with BT that the paragraphs in the Final Statement which deal with material changes in circumstances (ie paragraphs 6.23 to 6.26) do not set out exhaustive guidance as to what may amount to a material change in circumstances or how Ofcom might vary the Margin Condition were one to be found. In this regard, we acknowledge that Ofcom could have gone further than it did, so as to provide some further guidance to meet the concerns raised by BT in relation to its inability to act or take commercial decisions with any certainty as to how Ofcom will deal with changes to its commercial offering. That said, the question we are required to determine, as Ofcom rightly asserts, is not whether Ofcom could have gone further, but rather whether Ofcom has erred in its treatment of material changes in circumstances in the Final Statement.
- 7.105 It is clear that the focus of BT's argument is in relation to its commercial operability. In particular, BT asserts that, were it to bid for new rights (whether these be in relation to sports rights or entertainment packages) and has to conclude commercial deals that have large, fixed costs associated with them, BT does not have certainty under the Final Statement as to whether the Margin Condition will be adjusted from its standard approach, nor how it might be adjusted.⁵³³
- 7.106 Having considered BT's argument, we have found that the Final Statement is not so vague as to provide no effective guidance in relation to material changes in circumstances.
- 7.107 We accept that Ofcom's treatment of material changes in circumstances in the Final Statement does not provide exhaustive guidance as to how it might deal with, for example, a change to BT's commercial offering. However, we note that BT did not provide any proposals as to how the Final Statement could be

⁵³¹ BT AmNoA, paragraph 153.

⁵³² Ofcom defence (BT Appeal), paragraph 249.

⁵³³ BT hearing transcript, p139.

amended to provide a greater measure of precision and certainty in this regard, particularly given the inherent difficulty in predicting the nature of any future change in circumstances and its potential impact.⁵³⁴

7.108 In contrast, Ofcom was asked to explain why it had decided not to include further detail in the Final Statement as to the changes in circumstances which might be sufficiently material to justify a departure from the guidance and/or the procedure Ofcom might follow were it to find a material change in circumstances.⁵³⁵ Ofcom explained that:

- (a) it was not possible to provide an exhaustive list of each and every possible change that might require a departure from the guidance contained in the Final Statement or how it might respond to such changes;
- (b) even if it had sought to include some additional guidance/principles within the Final Statement, such a task would be difficult to undertake given that, by their nature, such material changes in circumstances are difficult to predict or foresee; and
- (c) accordingly, if it had set out some very general principles, it is unlikely that those principles would have assisted BT and would not have provided BT (or any other CP) with a greater degree of certainty in this regard.

7.109 We have considered what further guidance Ofcom could have included in the Final Statement, in particular, whether Ofcom could have included (i) a non-exhaustive list of circumstances that may amount to material changes, (ii) some criteria against which Ofcom would determine whether there had been a material change in circumstance, or (iii) guidance as to the procedure that Ofcom would follow where a material change in circumstances is found.

7.110 In relation to the provision of a non-exhaustive criteria or some other criteria against which Ofcom will determine a material change in circumstances, we agree with Ofcom that this would not necessarily provide BT with a greater degree of certainty, within the constraints of what Ofcom could reasonably have been expected to foresee.

⁵³⁴ BT hearing transcript, pp135–139.

⁵³⁵ Ofcom hearing transcript (BT Appeal), pp108–110.

- 7.111 We agree with Ofcom that many material changes in circumstances are not foreseeable and are, by their nature, uncertain and difficult to specify in regulation.⁵³⁶
- 7.112 We also agree with Sky's observation that Ofcom's decision to 'reserve a right to address material changes in circumstances simply reflects its obligations as part of its ongoing regulatory role. It is in the nature of future, unpredicted changes in circumstances that they cannot be circumscribed in advance'.⁵³⁷
- 7.113 Further, even if Ofcom were minded to set out non-exhaustive guidance of the sort mentioned above, BT would still be required to make an application to, or seek clarification from, Ofcom as to whether a change in its commercial offering would amount to a material change in circumstances. Given that Ofcom would still be required, in the first instance, to determine this question (ie whether a change in BT's business model did or did not amount to a material change in circumstance), BT would – on its own argument – still suffer the same lack of alleged clarity as to what may amount to a material change in circumstance. We think this is an inescapable part of the flexibility Ofcom has sought to include in the Final Statement and, far from creating uncertainty, provides Ofcom, as a specialist regulator, with the ability to determine matters on a case-by-case basis.
- 7.114 Our view is that the guidance set out in the Final Statement⁵³⁸ provides sufficient legal certainty as to what may amount to a material change in circumstances.⁵³⁹ It is clear that Ofcom will first consider whether there has been a significant change to BT's business model for SFBB and, if so, it will then go on to consider how the Margin Condition needs to be varied.⁵⁴⁰ In the light of this, we are of the view that a non-exhaustive list or some other criteria would not necessarily provide any greater degree of certainty to BT. We therefore determine that Ofcom has not erred by not providing further guidance as to what may amount to a material change in circumstances.
- 7.115 We agree with Ofcom that a certain degree of flexibility must necessarily be built into the Final Statement about how it might proceed once it has found that there has been a material change in circumstances. We also agree that any decision as to how to vary the Margin Condition in response to a particular material change will require dialogue between Ofcom and BT, and will require some form of consultation with stakeholders on the most

⁵³⁶ Ofcom defence (BT Appeal), paragraph 152.

⁵³⁷ Sky Sol, paragraph 66.

⁵³⁸ Final Statement, paragraphs 6.23–6.26.

⁵³⁹ Final Statement, paragraphs 6.23 & 6.24; ie a significant change to BT's business model for SFBB, such as an extra feature or product being added to its SFBB bundles for which it charges customers.

⁵⁴⁰ Final Statement, paragraphs 6.23 & 6.24.

appropriate way to proceed (as, in fact, happened in relation to the UEFA channels).

7.116 While we accept that Ofcom could possibly have included further detail as to the process/procedure to be followed where a material change in circumstances is found, we do not think that its failure to do so means that the Final Statement breaches the principle of legal certainty. In our view, paragraphs 6.25 to 6.26 of the Final Statement provide sufficient certainty as to how Ofcom might respond in particular circumstances, whilst also retaining sufficient flexibility in circumstances where it cannot predict the circumstances in which a variation to the VULA margin condition may be required.

7.117 Having considered BT's principal argument set out above, we have come to the conclusion that Ofcom has not erred in relation to its treatment of material changes in circumstances in the Final Statement for the reasons given above.

7.118 We consider that the guidance Ofcom has provided is sufficiently clear and provides legal certainty to BT (and other communications providers), whilst ensuring that Ofcom has retained sufficient flexibility, in the Final Statement, to allow it to adapt the Margin Condition to reflect changes in circumstances which cannot, by their very nature, be predicted.

- *Additional arguments raised by BT*

7.119 We consider that our findings on BT's principal argument are sufficient to dispose of this reference question in its entirety. However, for the sake of completeness, we address the additional arguments relied on by BT under reference question 2.

7.120 First, we address BT's complaints arising out of the correspondence between BT and Ofcom in April 2015 relating to the proposed launch of BT's UEFA channels. We note, in this regard, that BT asserts that the uncertainty in Ofcom's approach in the Final Statement has been demonstrated, and yet further compounded, by Ofcom's response to BT's letter of 21 April 2015.

7.121 We do not find BT's additional arguments relating to this correspondence to be relevant, given that matters were overtaken by the subsequent consultation relating to the launch of BT's UEFA channels and the publication of the Supplementary Guidance. As we have set out in paragraphs 7.115 to 7.116 above, we consider that it is inherent in any regulatory framework that the regulator must have sufficient flexibility to decide, in the first instance, whether a particular change in circumstances is sufficiently 'material' and, thereafter, to determine what action to take in light of that change in circumstance.

- 7.122 We note that BT seeks to argue that Ofcom's letter of 21 April 2015 did not provide clear guidance to BT as to the approach Ofcom would take in relation to the costs of UEFA content and, in particular, what Ofcom meant in relation to its proposal for deferral of those costs. However, we agree with Ofcom that this part of BT's complaint is largely academic, for the reasons set out in paragraph 233 of its Defence.
- 7.123 As to BT's assertion that the approach set out in the letter of 21 April 2015 would effectively be retrospective in approach, we also find this complaint to be academic, given the subsequent publication of the Supplementary Guidance.
- 7.124 Second, we note that BT makes a number of criticisms about Ofcom's decision to consult on its proposed approach having found the launch of the UEFA channels to amount to a material change in circumstances.
- 7.125 We do not consider that the decision to consult demonstrates that the guidance contained in the Final Statement is either unsatisfactory or uncertain, as BT alleges. We have explained why we think the guidance in the Final Statement provides sufficient legal certainty to BT and also why we consider that Ofcom must retain a certain degree of flexibility to allow it to determine matters once it has found a material change in circumstances. Further, where Ofcom accepts that a change to BT's commercial offering is sufficiently material to justify a departure from the guidance in the Final Statement, it is our view that Ofcom is likely to be required, pursuant to its public law duty of fairness, to consult on any amendment to, or departure from, the guidance contained in the Final Statement. Accordingly, it seems to us that there would be an unavoidable need for some form of consultation by Ofcom in these circumstances.
- 7.126 Third, in relation to the Supplementary Guidance itself, BT asserts that this provides no certainty as to (i) the circumstances that may, in the future, be regarded by Ofcom as sufficiently serious to justify a further variation, and (ii) the manner in which Ofcom might consider it appropriate to vary the decision. We reject this argument for the reasons given above.
- 7.127 Finally, and more generally, we agree with Ofcom that, when considering whether a condition complies with legal certainty, it is right to take account of all of the circumstances. This includes the practical reality that BT was able to communicate with Ofcom to gain greater clarity as and when required. In our view, that is what happened in the present case and led to the publication of the Supplementary Guidance.

Reference question 4(i)

7.128 We have also considered the arguments raised by both BT and Ofcom in relation to reference question 4(i). We agree with Ofcom that this reference question raises the same points as raised by reference question 2.⁵⁴¹ We note that BT, in its Core Submission Volume 2, accepts this.⁵⁴²

7.129 Given our findings on reference question 2, we consider that Ofcom has not erred in imposing a regulatory condition on BT that fails to provide the requisite transparency in relation to what it is intended to achieve. We consider the Margin Condition to provide sufficient certainty and transparency and, therefore, consider that Ofcom has not, by virtue of its treatment of material changes in circumstances in the Final Statement, breached section 47(2) of the Act.

Our determination on reference questions 2 and 4(i): Legal certainty and transparency

7.130 In its response to our provisional determination, BT invited us to reconsider our determination on legal certainty, reiterating the difficulties it faces in making major strategic investments and commercial decisions without knowing in advance whether Ofcom may be prepared to modify its operation of the Margin Condition in some unspecified way.⁵⁴³ We have considered the points raised by BT in this part of its response to our provisional determination, but do not consider that they take BT's argument any further.

7.131 For the reasons given above, we determine that Ofcom has not erred in relation to reference question 2.

7.132 Given our findings on reference question 2, we determine that Ofcom has not erred with respect to reference question 4(i) in imposing a regulatory condition on BT that fails to provide the requisite transparency in relation to what it is intended to achieve.

8. BT Appeal: Assessment of Remedy

Introduction

8.1 As set out in paragraph 4.76, we have determined that, in relation to reference question 3(b), Ofcom erred in imposing a one-month compliance period.

⁵⁴¹ Ofcom defence (BT Appeal), paragraph 580.

⁵⁴² BT core submission, volume 2, paragraph 278.

⁵⁴³ BT response to our provisional determination, paragraphs 119–121.

8.2 Given that we have found that Ofcom to have erred in this respect, we are required, in accordance with reference question 6, to include in our determination insofar as is reasonably practicable: (i) clear and precise guidance as to how this error should be corrected; and (ii) a determination as to any consequential adjustments to the Price Control.

Our process for considering remedies

8.3 On 11 April 2016, we notified the parties that we had provisionally determined that Ofcom had erred in relation to the imposition of the one-month compliance period.

8.4 On the same date, we sent the parties a remedies letter ('the Remedies Letter'), in which we invited initial submissions as to an appropriate remedy on the basis of our provisional determination. We received the parties' responses to the Remedies Letter on 6 May 2016.

8.5 On 25 May 2016, we held a remedies hearing, at which BT, Ofcom and TalkTalk made submissions to us on what they considered to be the appropriate remedy to correct the error we had identified in our provisional determination and we questioned the parties to examine and clarify their remedies proposals.

8.6 The parties also made comments in relation to the option of remittal and the time available for any remedy, including the appropriate way of dealing with the period from the CAT's judgment on the specified price control matters to the end of the current Margin Condition in March 2017.

Proposed design of the remedy

8.7 In the Remedies Letter, we said that we considered the most reasonable starting point for a remedy would be to adjust the compliance period to a period of greater than one month. We indicated that we were minded to:

- (a) extend the compliance period to six months;
- (b) apply this on a fixed-date basis;
- (c) retain the current reporting requirements on BT (including the provision of monthly data); and
- (d) retain the current calculation of costs and revenues for each monthly cohort of customers.

8.8 Our initial view, as set out in the Remedies Letter, was that combining a six-month compliance period with a fixed-date approach would strike a better balance between providing flexibility to BT and ensuring that Ofcom's objectives in the Margin Condition were not undermined.

Proposed approach to implementation

8.9 The Remedies Letter also set out our proposed approach to implementation of the remedy.

8.10 We noted that the Margin Condition includes the Legal Instrument at Annex 2 to the Final Statement and the Guidance at Annex 3. Our initial view was that Ofcom should amend the Legal Instrument and the Guidance to reflect the longer compliance period and to take account of any consequential amendments that might be required.

8.11 In its response to the Remedies Letter, Ofcom agreed with our view that some changes would be required to both the Legal Instrument and the Guidance. It enclosed marked-up versions of both documents, setting out the changes that it considered could be included in the CAT's directions giving effect to our final determination.

8.12 Prior to the remedies hearing, BT informed us that it would liaise with Ofcom in advance of the hearing with a view to producing agreed drafts of the Legal Instrument and Guidance with Ofcom, or at least seeking to narrow the areas of any disagreement. BT wrote to us on 20 May 2016 setting out its proposed changes to Ofcom's marked-up documents.

8.13 We set out at appendices C and D our changes to the Legal Instrument and the Guidance: Appendix C: Condition 14 – Virtual Unbundled Local Access margin control, as amended, and Appendix D: Guidance on assessment of the VULA margin, as amended.

8.14 We consider it is not necessary to remit the Margin Condition to Ofcom to remedy. We consider that there is a simple and effective remedy to correct the error we have found. Ofcom supports this approach and BT's comments on Ofcom's proposed approach were limited to alternative approaches to the points discussed below.⁵⁴⁴

⁵⁴⁴ Remedies hearing transcript, p32.

8.15 At the end of this section, we discuss the arrangements to be put in place for the initial period, in order to specify the start and end dates for the amended compliance period.

The proposed remedy

8.16 In this section, we first consider the length of the compliance period, summarising the parties' responses to our Remedies Letter and the evidence and submissions given in the remedies hearing.

8.17 We then consider the treatment of the net costs of BT Sport and the provision of product-level data, setting out for each the parties' proposals and responses to our Remedies Letter, and the evidence and submissions given in the remedies hearing.

Length of compliance period

BT

8.18 In response to the Remedies Letter, BT accepted that extending the length of the one-month compliance period would introduce a degree of additional flexibility for BT in its commercial activity. In terms of its proposals on the appropriate remedy, it considered that a 12-month, fixed-date compliance period with annual reporting aligned with BT's financial reporting year would be appropriate.⁵⁴⁵ BT also agreed that the current basis for calculating monthly costs and revenues should be retained except those relating to BT Sport.

8.19 BT explained its reasoning as set out below.

- *Consistency with statutory regime and regulatory objective*

8.20 BT stated that in its view, a 12-month fixed-date compliance period with annual reporting was sufficient to ensure that an efficient rival of BT was able to purchase VULA and compete profitably. Any shorter compliance period would go beyond that which was necessary to meet Ofcom's stated regulatory objective and its associated statutory duties.

8.21 BT's position was therefore that a compliance period of 12 months was proportionate to the aims of the Margin Condition.

⁵⁴⁵ BT's year end is 31 March.

8.22 In particular, BT considered that a compliance period of 12 months would be sufficient to meet Ofcom's regulatory objectives. BT stated that:⁵⁴⁶

- (a) it did not agree that there was a valid concern about BT 'gaming' any additional flexibility in the compliance period;
- (b) if by 'gaming', Ofcom considered that BT could reduce margins during part of the period and increase them in the rest of the period, BT's competitors would still be able to match BT's offers profitably across the totality of the period; and
- (c) a [✂] share of the costs within the VULA margin were not driven by the acquired cohort, and it would be wrong for the CMA to give weight to a concern that the margin may be 'low' for part of the compliance period.

8.23 BT stated that its proposal would not cause rivals any difficulties in practice nor would it weaken Ofcom's ability to ensure that BT maintained a sufficient margin to protect competition and consumers.

8.24 In the remedies hearing, BT made the following points regarding the overall question of the approach:⁵⁴⁷

- (a) BT stated that, while the CMA had indicated in CC13 that as a matter of administrative policy it will not go further than is needed to remedy any defects identified, its statutory obligation is to make the condition lawful; so in formulating a remedy the CMA steps into Ofcom's shoes and it cannot direct Ofcom to take action that Ofcom itself could not otherwise take.
- (b) BT also stated that any remedy must be directed at and proportionate to the relevant risk that has been identified and must not impose a restriction beyond what is needed for that purpose; a 12-month fixed-date compliance period would be a sufficient and proportionate remedy, because it was sufficient to meet Ofcom's stated regulatory aim and its associated statutory duties, and also to meet the CMA's preference for simplicity and ease of implementation, given that it coincided with BT's financial year.

8.25 From the above arguments, BT said that it followed that the additional restriction inherent in a six-month compliance period would go beyond what

⁵⁴⁶ BT's response to the Remedies Letter, paragraphs 19–24.

⁵⁴⁷ Remedies hearing transcript, pp6–7.

was necessary and would therefore be both contrary to Article 8(4) of the Access Directive⁵⁴⁸ and disproportionate.

8.26 Also in the remedies hearing, BT stated that a 12-month compliance period was the 'orthodox approach' and it had seen such a period applied in various charge controls.⁵⁴⁹

- *Simplicity and ease of implementation*

8.27 BT considered that the application of a 12-month period was simple and easy to implement. It accepted that the current VULA margin model used for reporting compliance to Ofcom could be used as the starting point for considering what specific data submissions should be made to Ofcom and how calculations of margin for a longer compliance period should be made. BT stated that compliance with a test applied to margin earned over a 12-month period could be assessed by deriving a volume-weighted average of the 'headroom' shown within the model for individual months.

8.28 BT stated that submitting data across a 12-month compliance period, which was aligned with BT's financial reporting year, to show the average margin made over that compliance period would address the error that we had found with respect to the one-month compliance period. It would also carry the advantages of simplicity and ease of implementation, in line with the principles set out in CC13⁵⁵⁰ considering the appropriateness of remedies design.

8.29 BT stated that there were clear efficiency advantages in moving to annual reporting of compliance for each financial year compared with alternatives such as more frequent reporting of rolling averages across 12-month periods.

- *Commercial flexibility and customer response*

8.30 In the hearing, BT responded to the points regarding 'gaming' which Ofcom and TalkTalk alleged against the 12-month compliance period. BT argued that if the flexibility were provided, harm to competition would be driven by the extent to which BT could maintain a low enough margin for sufficiently long periods within that longer compliance period, combined with volume effects. It said a low price would be expected to drive higher volumes, so the challenge would be that a later period of higher prices would fail to drive sufficient

⁵⁴⁸ Directive 2002/19/EC of the European Parliament and of the Council of 7 March 2002 on access to, and interconnection of, electronic communications networks and associated facilities (Access Directive) OJ (2002) L108/7.

⁵⁴⁹ Remedies hearing transcript, p10.

⁵⁵⁰ [CC13, Annex B, paragraph 3.](#)

volumes to pass the test across the 12-month period.⁵⁵¹ BT also stated that, in any period where it had to raise prices to ensure that it passed the test across the compliance period, it could introduce other products, such as mobile elements, into its bundle in order to make it more attractive.⁵⁵² BT stated that it was not credible to suppose that BT could run a truly exclusionary and harmful margin squeeze for a part of the 12-month period such that excess returns could in some way be earned after competition itself had been diluted.⁵⁵³

- 8.31 BT added that, even if it ignored competition law constraints, the simple fact was that efficient rivals could compete either by choosing to match BT's price exactly through the year, knowing that they would earn back the LRIC+ across that period, or by adopting alternative commercial strategies that may well be commercially preferable for them to do in light of whatever they observed about BT's pricing through that period.⁵⁵⁴
- 8.32 BT also repeated its argument that the requirement to comply with the Margin Condition acted as an overall constraint on what it could do,⁵⁵⁵ and that a six-month test would place greater constraints on the freedom to recover common costs and the prices it would be able to charge than a 12-month test.⁵⁵⁶ BT stated that it wanted the freedom to set prices in that period, to drive volumes, to react to market conditions, and to introduce more elements into its commercial offers, such as bundles, that drive incremental revenues.⁵⁵⁷ BT cited the example of higher rights costs in respect of the Premier League which would come into effect in August 2016, and consequential price increases which it had already announced. BT stated that it would have greater freedom over its approach to pricing in such circumstances if it had a 12-month flexibility in the recovery of common costs as opposed to a six-month recovery period.⁵⁵⁸ It stated that it wanted the flexibility so that when it faced different challenges through the year it was able to move prices in a way that was enabling it to compete on the merits with its rivals.⁵⁵⁹

⁵⁵¹ Remedies hearing transcript, pp7–10.

⁵⁵² Remedies hearing transcript, p21.

⁵⁵³ Remedies hearing transcript, pp7–10.

⁵⁵⁴ Remedies hearing transcript, pp9-10.

⁵⁵⁵ Remedies hearing transcript, p10.

⁵⁵⁶ Remedies hearing transcript, p13.

⁵⁵⁷ Remedies hearing transcript, p13.

⁵⁵⁸ Remedies hearing transcript, pp13-14.

⁵⁵⁹ Remedies hearing transcript, p19.

Ofcom

- 8.33 In its response to the Remedies Letter, Ofcom indicated that the length of the compliance period was a matter of regulatory judgement which involved balancing the risks to competition against the loss of flexibility for BT.
- 8.34 Ofcom went on to explain that, while arguments could be made for a shorter period, it had no particular objection to our proposal for a six-month compliance period. Ofcom did state, however, that it would be concerned if the compliance period were extended beyond six months on the basis that this may enable BT to implement the type of anti-competitive behaviour that the Margin Condition was seeking to address.
- 8.35 In subsequent correspondence in advance of the remedies hearing, Ofcom reiterated its views as follows:
- (a) A long compliance period could result in BT setting low margins for a period, before subsequently raising them to ensure compliance. This could distort competition. This risk would be increased if BT were able to implement an extended period of low margins over multiple periods which could allow the behaviour that the Margin Condition was designed to prevent.
 - (b) Risks were particularly acute during the current critical time period in SFBB development and in the context of a market where BT was performing very strongly.
 - (c) A number of the parameters were already smoothed, reducing any seasonal effects, so a longer compliance period was not necessary to address seasonality.
- 8.36 Ofcom also explained we should be mindful that the compliance period may extend beyond the conclusion of Ofcom's next review of the wholesale local access market. In the event that changes were made to the application of the Margin Condition before the end of the (extended) compliance period, there was a risk that the Margin Condition would be rendered ineffective for the entirety of the final compliance period. Ofcom stated that, whilst this risk existed for any compliance period in excess of a month, it was clearly more acute as the length of the compliance period increased.
- *Remedies hearing*
- 8.37 In the remedies hearing, Ofcom reiterated that it saw the decision between a six-month and a 12-month compliance period as a judgement and a trade-off

between the effect on competition and BT's flexibility. It stated that, given the current market circumstances, it had always favoured a shorter time period.⁵⁶⁰

- 8.38 Ofcom stated that BT had been performing very well in SFBB and had continued to do so even under the monthly compliance regime, and the concern was that any extra flexibility could lead to a harm to competition. Ofcom went on to state that it was mindful that TalkTalk seemed less well placed in relation to SFBB than Sky or BT. Its concern was that by setting a low margin, it would discourage TalkTalk from competing and building up subscribers in SFBB.⁵⁶¹
- 8.39 Ofcom reiterated its arguments set out in Section 3 of its Final Statement that the market was transitioning from SBB to SFBB and that Ofcom's intention was to create a stable environment for other companies to be confident in making an investment.⁵⁶² As the time period for compliance was extended, there would be more scope for prolonged periods of uncertainty, and such uncertainty would undermine the willingness of BT's rivals to invest.⁵⁶³
- 8.40 Ofcom responded to BT's point that other charge control periods were over a 12-month period. It said that although some were on an annual basis, for example, leased line charge controls, others were on a much more granular basis. It provided the example of mobile call termination charges where the charge control applied daily.⁵⁶⁴
- 8.41 In its closing statement, Ofcom stated that the current regime with a one-month compliance period had been in place for 14 months and was not actually causing problems for BT. It noted that BT had launched its UEFA channels in 2015 and had asked Ofcom under the material change in circumstances provisions to provide more flexibility. Ofcom had done so but BT had not needed to use that flexibility. Ofcom stated that it was not clear that even the one-month regime had been overly restrictive on BT.⁵⁶⁵
- 8.42 Finally, with regard to the approach to take from a legal perspective, Ofcom stated that the compliance period should be the longest period justified before concerns about competition problems arise.⁵⁶⁶

⁵⁶⁰ Remedies hearing transcript, pp32.

⁵⁶¹ Remedies hearing transcript, pp34.

⁵⁶² Remedies hearing transcript, pp40.

⁵⁶³ Remedies hearing transcript, p43.

⁵⁶⁴ Remedies hearing transcript, pp48-49.

⁵⁶⁵ Remedies hearing transcript, pp82-83.

⁵⁶⁶ Remedies hearing transcript, p53.

TalkTalk

- 8.43 In its letter of 6 May 2016 in advance of the remedies hearing, TalkTalk emphasised that the CMA's remedy 'must go no further than is necessary to correct for Ofcom's error', and we should therefore choose the shortest period which we would not have considered to be an error.
- 8.44 TalkTalk stated that we could only accept BT's submission that the compliance period should be 12 months if we would have found that any shorter period (such as six months) – if originally chosen by Ofcom – would also have been in error. TalkTalk considered that this was not plausible on the facts of this case. TalkTalk explained that the unduly restrictive nature of a monthly compliance period, which we have found, would not apply to a six-month compliance period. TalkTalk suggested that a three-month compliance period would be adequate.
- 8.45 TalkTalk then explained its concerns in relation to a 12-month compliance period. It was particularly concerned with the possibility of this leading to a prolonged period of reduced margins over multiple periods and the risks associated with this, for example, predatory behaviour and regulatory gaming. These were the same concerns identified by Ofcom.
- 8.46 Finally, TalkTalk raised two further concerns:
- (a) A 12-month compliance period would provide sufficient room for BT significantly to damage its rivals' businesses before regulation would take effect. For example, BT could seek to engineer a situation where its rivals obtained a reputation for offering poor value products compared to those of BT.
 - (b) Longer compliance periods would compromise Ofcom's ability to ensure that BT adhered to the Margin Condition. For example, it invited us to consider a scenario in which BT chose to set a low price for the first six months of the 12-month compliance period, with the intention of increasing margins in the second half of the year. However, if the UK economy then went into recession and demand reduced in the second six months, it could be impossible for BT to comply with the Margin Condition by setting higher prices over the second half of the year. The longer the regulatory compliance period, the more likely such 'external shocks' would have a material effect. A 12-month period was sufficiently long to run the risk of regulation being adversely affected by such external shocks.

- *Remedies hearing*

- 8.47 TalkTalk stated that a three-month compliance period would be adequate to provide BT with additional flexibility but in considering either six or 12 months, it came down on the side of six months.⁵⁶⁷ TalkTalk also stated that it supported Ofcom regarding the manner in which ‘gaming’ could occur.⁵⁶⁸
- 8.48 In response to BT’s case that other operators could match BT’s offers,⁵⁶⁹ TalkTalk made an argument about informational asymmetry. It said that it would not know where BT’s pricing sat relative to the margin test at any point in time. For example, although BT might be pricing below the cost as assessed by the model, TalkTalk would be forced to a great extent to expect that BT’s pricing was broadly at a floor set by the Margin Condition and that it could not assume that it would be going up again in the future.⁵⁷⁰ This would have an impact on investment decisions and make it very difficult to plan for investing in its business where this required reasonable expectations about profitability.⁵⁷¹
- 8.49 TalkTalk thus argued that an extended margin squeeze that could occur from a 12-month compliance period raised a greater risk to its financial stability compared to a six-month compliance period.⁵⁷²
- 8.50 In its closing statement, TalkTalk summarised its position as follows: ‘the overwhelming point is that the shorter the compliance period is, the better that is for ensuring that we face a low risk, we are able to invest in upgrading customers, and that we have sufficient certainty in order to take the right commercial actions at each point on time’.⁵⁷³

Sky

- 8.51 Sky provided no comments on the design or implementation of the proposed remedy.

- *Our assessment of the length of compliance period*

- 8.52 We consider that any assessment of the length of the compliance period appropriate to remedy the error we have found is a matter of regulatory

⁵⁶⁷ Remedies hearing transcript, p58.

⁵⁶⁸ Remedies hearing transcript, p58.

⁵⁶⁹ BT response to Remedies Letter, p6; also Remedies hearing transcript, p8.

⁵⁷⁰ Remedies hearing transcript, p60.

⁵⁷¹ Remedies hearing transcript, p62.

⁵⁷² Remedies hearing transcript, p61.

⁵⁷³ Remedies hearing transcript, p84.

judgement. Such a judgement involves balancing the risks to competition against the loss of commercial flexibility for BT.

8.53 Ofcom stated in the remedies hearing that ‘A shorter compliance period potentially gives more certainty to competitors; a longer compliance period gives more flexibility to BT’.⁵⁷⁴ We agree with this and we have considered the evidence provided in coming to a final view on the judgement between these two considerations.

8.54 We have considered the following in our assessment, which we discuss in turn below:

(a) Relevant legal background.

(b) Risk to competition.

(c) Commercial flexibility.

- *Relevant legal background*

8.55 CC13 states the following:

(a) The [CMA] will not expect to devise any remedies other than those that are directly necessary to correct any errors identified in its finding, provided this does not lead to an unreasonable outcome.⁵⁷⁵

(b) Remedies will normally follow an approach that is consistent with that adopted in Ofcom’s original decision.⁵⁷⁶

(c) Simplicity and ease of implementation will be a key consideration in selecting remedies.⁵⁷⁷

(d) In general, the [CMA] will try to bring the price control to where it would have been if Ofcom had not made the identified error. It may be that Ofcom would or could have made a number of different decisions at that stage. Under these circumstances the [CMA] would normally seek to diverge as little as possible from the path that Ofcom actually took.⁵⁷⁸

8.56 In accordance with CC13, our aim is to follow an approach which is consistent with that adopted in Ofcom’s original decision, but correcting the error we have identified. Similarly, we have sought to balance the effectiveness of the

⁵⁷⁴ Remedies hearing transcript, p81.

⁵⁷⁵ [CC13, Annex B, paragraph 1.](#)

⁵⁷⁶ [CC13, Annex B, paragraph 2.](#)

⁵⁷⁷ [CC13, Annex B, paragraph 3.](#)

⁵⁷⁸ [CC13, Annex B, paragraph 4.](#)

remedy against excessively onerous consequences for BT, to ensure that our remedy does not lead to an unreasonable outcome.

- *Risk to competition*

- 8.57 With both six- and 12-month compliance periods, we have taken into account the possibility that BT would price below LRIC+ within the compliance period. In addition, we considered that this raised the possibility that BT could 'link' two compliance periods together, thereby pricing below LRIC+ for double the amount of time compared to a single compliance period. Over a 12-month compliance period, because of volume effects, we consider this could be up to five months. By linking two compliance periods together, BT could therefore possibly price below LRIC+ for a period of up to ten months.
- 8.58 We accept the point in BT's response to our Remedies Letter⁵⁷⁹ that its competitors would have an expectation that BT would comply with the Margin Condition across the compliance period and therefore that its average prices would be consistent with Ofcom's LRIC+ cost standard.
- 8.59 However, we agree with Ofcom and TalkTalk that a 12-month compliance period would allow BT to price below LRIC+ over two compliance periods by as much as ten months, while still having average prices for the relevant period which complied with the Margin Condition. There are likely to be some circumstances where this could create an appreciable risk to competition within and potentially across compliance periods. In other words, we are persuaded that there is some risk associated with BT applying the flexibility inherent in a long compliance period, which we understand to be characterised by Ofcom as 'gaming'.⁵⁸⁰
- 8.60 We therefore agree with Ofcom that an extended period of pricing below LRIC+, while complying with the requirements of a 12-month compliance period, would introduce risk to the achievement of Ofcom's stated regulatory aim of promoting competition.
- 8.61 In that context, we have taken account of TalkTalk's arguments that, due to informational asymmetry, it would not have visibility of where in relation to LRIC+ BT was pricing at any given point and that this difficulty would increase with a longer compliance period. We also agree with TalkTalk that this uncertainty in pricing would be likely to have some form of detrimental effect on BT's competitors' plans and therefore on opportunities for investment. We consider it relevant that Ofcom argued that this was an important point in the

⁵⁷⁹ Paragraph 17.

⁵⁸⁰ Remedies hearing transcript, pp33-34.

development of competition in the SFBB market and that a longer compliance period would put this at risk.

8.62 While it is inevitably a matter of judgement, it seems to us that TalkTalk has made a reasonable case that there is some risk that a 12-month compliance period would be sufficiently long for BT to damage its rivals' businesses. In particular, it would allow BT to keep its prices below the level identified by Ofcom as being capable of being matched by an adjusted EEO, for a sufficiently long period that could have an effect on market conditions.

8.63 Finally, we have also considered TalkTalk's argument about the risk that external shocks might have on BT's compliance in a 12-month compliance period. However, we are not persuaded that such a risk would compromise Ofcom's ability to ensure BT adhered to the Margin Condition and therefore we do not consider this a relevant factor in our decision.

- *Commercial flexibility*

8.64 BT told us that it required pricing flexibility in order to carry out its commercial strategy. However:

(a) even with the one-month compliance period, BT has not to date breached the Margin Condition;

(b) BT requested additional flexibility around the launch of its UEFA channel, which Ofcom granted; however, BT had not made use of this additional flexibility and therefore it is not clear why a six-month compliance period would be overly restrictive on BT; and

(c) BT could not provide concrete examples of how a six-month compliance period would restrict its commercial flexibility compared to a 12-month compliance period.

8.65 BT did provide theoretical examples as to why it might require a longer compliance period. It referred to its ability to adjust to a sharp change in costs, comparable to the changes associated with the launch of the UEFA channels, or to take account of changes in its bundles. We agree that these are the types of events that are relevant to BT's argument that one month is too short. However, we consider BT did not demonstrate that a period as long as 12 months is required to allow it to implement a normal commercial strategy.

8.66 It is clearly a possibility that a circumstance could arise where the additional flexibility from a 12-month compliance period would benefit BT in responding to changes in competitive conditions. However, we are not persuaded that this would have been likely, other than in the context of a significantly sharp

change in market conditions where a 'one-off' review such as that implemented for UEFA content would be a more likely response.

Our conclusion on the proposed remedy

8.67 We consider that the choice between a six-month and a 12-month compliance period is a matter of regulatory judgement. In assessing what the appropriate remedy should be, we have balanced the risks to competition associated with a 12-month compliance period against the additional flexibility that a longer compliance period would give BT. On balance, we are persuaded that the risks to competition associated with a 12-month compliance period are such that a compliance period of six months amounts to the least onerous means of achieving Ofcom's regulatory aim.

8.68 We therefore consider that, in order to remedy the error we have found in relation to reference question 3(b), the compliance period should be extended to six months.

BT's alternative treatment of the net cost of BT Sport

BT

8.69 In response to the Remedies Letter, BT proposed changes to the approach to calculating the net cost of BT Sport in the context of a longer compliance period. The net cost of BT Sport is currently calculated in a separate model for each one-month compliance period, taking data sets from the BT Sport monthly P&L. BT stated that, in moving to a 12-month compliance period, it believed it would be appropriate to take account of observed growth in key data items across the 12-month period in establishing the net cost of BT Sport figure to use across the 60-month ACL.

8.70 Where growth is observed during the compliance period, to give more weight to higher figures at the end of the 12-month period (ie the exit rate) as more indicative of the net cost that would apply beyond the end of that period, BT proposed that a single 12-month net cost of BT Sport figure should be produced that would give weight to the exit rate data for that period. This would be expressed as a monthly cost and used for each month in the VULA margin model. Where growth over the 12-month period was observed in either or both of revenues and rights costs, the revenue and/or rights costs used in the net cost of BT Sport calculation would use the data from the full 12-month

period to derive average monthly revenues and costs over a 60-month period by taking:⁵⁸¹

$$\frac{\{ [\text{Sum of observed revenue/cost for 12 months of financial year}] + [\text{exit rate observed revenue/cost measure} \times 48] \}}{60}$$

60

- 8.71 In the hearing, BT provided further arguments in support of its proposed changes:
- (a) Taking the existing approach would be unduly restrictive on BT because the alternative exit rate approach, while still a simplification and still within the static projection approach that had been upheld, offered a better basis to make that projection of net cost across the expected average customer life and therefore aligned better with the commercial constraints that BT would face.
 - (b) The exit rate approach fitted closer to the principles set out in Ofcom's Final Statement.

Ofcom

- 8.72 Ofcom stated that the current approach already included a mechanism for reflecting the benefits of growing BT Sport revenues.
- 8.73 Although it recognised that this was not the only possible approach, it stated that it was not clear why the change proposed by BT was necessary to address the error provisionally identified.

TalkTalk

- 8.74 TalkTalk contended that changing the approach to BT Sport costs did not follow as a remedy to a one-month compliance period.
- 8.75 TalkTalk also considered that BT's alternative approach provided BT with 'a clear opportunity for regulatory gaming' due to the substantially greater weighting (49 times) of the final month over the others. This would result in both the ability, and strong incentives, to increase observed revenue in that month which would reduce the net cost of Sport for all customers acquired that year (if using a 12-month compliance period).

⁵⁸¹ Note: CMA added { } brackets to make formula reflect what BT actually proposed.

8.76 Finally, TalkTalk noted that BT Sport had been transmitted for nearly three years, and so building a regulatory regime around the implicit assumption that growth would continue was not sustainable.

Our assessment

8.77 Both Ofcom and TalkTalk described any changes to the calculation of BT Sport costs as being unnecessary to correct an error with a one-month approach.

8.78 We agree that a change is not required. However, a longer compliance period would allow for an approach not previously possible under a monthly compliance period. Specifically, since the customers during the compliance period have different allocated costs of BT Sport, one could adopt the latest of these to apply to the overall cohort. We therefore consider BT's proposed alternative as part of the overall remedy.

8.79 BT's approach could be argued to be a more accurate representation of the net cost of BT Sport where there is a clear and unambiguous trend in that calculation. While BT's evidence demonstrates trends in both the costs and direct revenues associated with BT Sport, BT did not provide clear evidence of a trend in the net cost of BT Sport. As discussed in Section 6, the evidence around the expected level of the net cost of BT Sport is [REDACTED].

8.80 On balance we do not consider that BT has demonstrated that the benefits of its alternative approach would outweigh the risks to competition for the following reasons:

(a) The net cost of BT Sport has fluctuated from month to month and giving significant weight to one month's data could result in an unrepresentatively high or low result as regards the Margin Condition in an individual month;

(b) Such an approach would create distortive incentives for regulatory gaming from the significantly higher weighting on revenue of a single month which would affect all customers for that six-month period;

(c) Both the risk of unexpected fluctuations and the opportunity for perverse incentives would be compounded by the fact that BT Sport revenue changes appear to be driven [REDACTED].

8.81 We have therefore decided to retain the approach within the Margin Condition to determining the net cost of BT Sport.

Continued provision of product-level data

8.82 In its response to the design of the remedy, TalkTalk asked us to modify our proposed remedy to include the ongoing collection by Ofcom of monthly data at the product group level. It highlighted our finding in the provisional determination that the existence of *ex ante* regulation at the portfolio level, and the resulting collection of up-to-date revenue and cost data, might enhance the effectiveness of *ex post* enforcement at the product-level.⁵⁸²

BT

8.83 BT stated that it had already provided Ofcom with product-level data, and was happy to continue to do so.

8.84 However, in BT's view, Ofcom may not be able to rely on this directly for *ex post* enforcement, since some of the allocations of LRIC+ were based on a portfolio level.

8.85 BT also submitted that any CMA remedy should only impose changes that are a result of Ofcom's errors.

Ofcom

8.86 Ofcom noted that BT currently provided 'a significant amount of data [...] which is disaggregated as between BT's different superfast broadband products'. It saw no reason why this would change.

Our assessment

8.87 BT and Ofcom's responses confirm our understanding that BT will continue to provide Ofcom with product-level data. We therefore do not consider this point further.

Dates of compliance period

8.88 Having decided that the compliance period should be extended to six months, we consider how such a compliance period should operate in practice, ie when it should start and end.

8.89 We see substantial practical benefits in aligning the compliance period dates with BT's own financial year. These benefits include:

⁵⁸² Provisional determination, paragraph 8.56.

- (a) minimising administrative burdens on BT by ensuring that internal monitoring and decision-making in relation to the Margin Condition can be incorporated into the standard schedule of BT's business;
- (b) being in line with Ofcom's own regulatory cycles (this will in turn minimise the risk of BT being subject to months with multiple regulatory constraints in place – notwithstanding the possibilities of delays in Ofcom's future programme which would affect this); and
- (c) being consistent with the approach Ofcom adopted in relation to the Relevant Periods in the Final Statement (which were also set at six months),⁵⁸³ and the approach proposed by BT in its response to the Remedies Letter (albeit for a six-month period rather than a 12-month compliance period).⁵⁸⁴

8.90 In light of the above, our preferred approach is to set the six-month compliance period based on BT's half-year dates of 1 April to 30 September and 1 October to 31 March.

8.91 However, given that the date of the CAT's decision on the specified price control matters in the BT Appeal is unknown, it is unlikely that the implementation of the remedy will coincide with BT's half-yearly reporting and, as a result, there is likely to be an interim period from the date of judgment to the start of the next six-monthly reporting period.

8.92 In deciding how the remedy should be implemented, we have taken into account the likelihood that BT will, at the time of the CAT's judgment on the specified price control matters, be part way through a six-month compliance period based on BT's half-year reporting schedule. We have also had regard to the Court of Appeal's judgment in *Vodafone Ltd and others v British Telecommunications plc*,⁵⁸⁵ by which the court held that the CAT cannot direct Ofcom to take action that it does not have power to take and that given the power to impose SMP conditions is prospective, 'the power to modify existing conditions is likewise a power to modify them with prospective and not retrospective effect'.⁵⁸⁶

8.93 We have also considered the scope of Ofcom's powers under section 45 of the Act. In particular, whether if there is an interim period from the date of the CAT's decision to the end of BT's half-yearly reporting period (ie 30 September or 1 April), any past performance by BT in that period can

⁵⁸³ [Final Statement](#), Schedule 1, paragraph 14.4(p).

⁵⁸⁴ BT response to the Remedies Letter, paragraph 5.

⁵⁸⁵ *Vodafone Ltd and others v British Telecommunications plc* [2010] EWCA Civ 391.

⁵⁸⁶ *Vodafone Ltd and others v British Telecommunications plc* [2010] EWCA Civ 391, paragraphs 40 and 44.

be taken into account for the purposes of compliance with the Margin Condition based on a six-month compliance period. For example, if the CAT were to hand down its decision in mid-August 2016, BT would be part way through a six-month compliance period aligned to its half-year reporting ending on 30 September 2016. The question would be whether Ofcom could assess the period from 1 April to 30 September 2016 on the basis of a six-month compliance period, taking account of the fact that BT had been complying, up to the CAT's decision, with a more onerous test.

- 8.94 We acknowledge that it would be possible to set a standalone interim compliance period from the date of the CAT's decision to the end of the relevant half-yearly reporting period. This would mean that the six-month compliance period which is aligned to BT's reporting date would then begin on either 1 October 2016 or 1 April 2017, as the case may be. In our view, it would be better for Ofcom to measure compliance with the Margin Condition on a six-month basis with immediate effect. In other words, if the CAT were to hand down its decision in August 2016, the initial compliance period would be the six months ending 30 September 2016. While the revised control would in practice only have effect on a forward-looking basis, the pricing for the period from the implementation of the remedy (ie the date of the CAT's decision) to 30 September 2016 would be required to ensure compliance with the Margin Condition over the six month period consistent with BT's reporting dates, including the period within which BT had also been required to comply with the additional constraint of the monthly test.
- 8.95 In our view, Ofcom has the power to impose a remedy on this basis, although this is ultimately a matter for the CAT. We note that, in *Vodafone Ltd and others v British Telecommunications plc*, the Court of Appeal, in rejecting an argument by BT that the revisions directed by the CAT were retrospective only in the sense that they 'touched on the past', indicated that the revisions 'did not merely refer to past events in order to determine the content of future obligations'.⁵⁸⁷ We consider that the revisions we are proposing in relation to the compliance period in this case are ones that are prospective in nature, but refer to past events (namely BT's compliance on a monthly basis with the current test up until the point of the CAT's decision) when considering compliance at the end of the six-month period. The effect is not to amend the Margin Condition retrospectively, but rather to take account of past compliance with a more rigorous regime for the purposes of the remainder of the interim compliance period.

⁵⁸⁷ *Vodafone Ltd and others v British Telecommunications plc* [2010] EWCA Civ 391, paragraph 41.

Conclusion

8.96 Pursuant to reference question 6 in the BT Appeal, we consider that the appropriate remedy to correct the error in relation to reference question 3(b) is for Ofcom to:

- (a) extend the compliance period to a period of six months, applied on a fixed-date basis; and
- (b) align the six-monthly compliance period to BT's half-yearly reporting schedule, namely 1 April to 30 September and 1 October to 31 March.

8.97 We also consider that Ofcom should retain (i) the current reporting requirements on BT, including the provision of monthly data to Ofcom; and (ii) the current calculation of costs and revenues for each monthly cohort of customers.

8.98 We have considered the amendments that are required in order to give effect to this proposed remedy. We consider that the remedy can be given effect by Ofcom amending the Legal Instrument and the Guidance. We therefore invite the CAT to direct Ofcom to amend the Legal Instrument and the Guidance in line with the proposed revisions which are marked up in the versions appended to this determination.⁵⁸⁸

9. TalkTalk appeal: Reference question 1 – A product-level test

Introduction

9.1 By reference question 1 in TalkTalk's appeal, we are asked to determine whether Ofcom erred in deciding not to supplement its portfolio level test with a product-level test, for the reasons set out in paragraphs 47 to 92 of TalkTalk's Amended Notice of Appeal.

Ofcom's approach

9.2 In its Final Statement, Ofcom considered the appropriate output increment to which the Margin Condition should be applied. It considered three options: a

⁵⁸⁸ See Appendix C and Appendix D. The majority of the amendments to the Legal Instrument and the Guidance were agreed between Ofcom and BT in the course of the remedies stage. We have, however, revised the definition of 'Compliance Period' to give effect to our conclusion that a six-month compliance period should be imposed. Further, we have deleted the definition of 'Relevant Period', as this term is no longer necessary when a six-month compliance period is substituted for the one-month compliance period.

total broadband approach; a total fibre portfolio approach; and an individual product/product group approach.⁵⁸⁹

- 9.3 Ofcom rejected the total broadband approach on the basis that its competition concerns related to the ability of BT's rivals to compete for SFBB subscribers, rather than broadband as a whole, so such an approach would not be effective in achieving its regulatory aim.⁵⁹⁰
- 9.4 Ofcom decided that a fibre portfolio test would be appropriate because this would provide BT with the flexibility to determine the margins on individual products within the portfolio. It considered this to be particularly desirable because fibre services are still developing, and because this would allow BT to decide what contribution to common costs should be made by different products.⁵⁹¹
- 9.5 However, Ofcom recognised that a fibre portfolio test would not in itself prevent BT pricing below cost on individual products, as this might potentially be offset with other high-margin products to ensure that the fibre portfolio as a whole still earned a positive margin.⁵⁹² As a result, Ofcom also considered whether it should complement the fibre portfolio test with additional product/product group level tests based on a LRIC standard. It noted that the use of a LRIC standard for the product-level tests would allow BT to retain flexibility as to how it recovers its common costs from different SFBB products.⁵⁹³
- 9.6 In its analysis of the need for additional product-level tests, Ofcom noted five reasons why these may be unnecessary:
- (a) BT's main competitors supplied a comparable portfolio of SFBB products, including voice and TV services.⁵⁹⁴ This meant that it might not matter if BT applied different margins to different offers, as its rivals could also supply those high margin offers and still be able to compete in the SFBB segment.
 - (b) There was no evidence that BT's current prices are loss-making.⁵⁹⁵

⁵⁸⁹ [Final Statement](#), paragraph 5.112.

⁵⁹⁰ [Final Statement](#), paragraphs 5.113 & 5.126.

⁵⁹¹ [Final Statement](#), paragraph 5.127.

⁵⁹² [Final Statement](#), paragraph 5.129.

⁵⁹³ [Final Statement](#), paragraph 5.130.

⁵⁹⁴ [Final Statement](#), paragraphs 5.114 & 5.125.

⁵⁹⁵ [Final Statement](#), paragraph 5.133.

- (c) A product-level assessment based on a LRIC standard was likely to be redundant, as the fibre portfolio test carried out on the basis of LRIC+ standard is considerably more stringent. This conclusion was based on evidence from an indicative assessment of product-level margins (over LRIC), which found that [§].⁵⁹⁶ Ofcom noted that this indicative assessment was informed by a detailed analysis of costs that was carried out as part of its earlier Superfast Broadband Competition Act Investigation.⁵⁹⁷
- (d) Ofcom noted that, to the extent there was some residual risk of BT pricing individual products below cost, *ex post* competition law may act as a constraint on such behaviour.⁵⁹⁸
- (e) Ofcom also commented that, if BT were to offset a low margin on entry-level SFBB products against a high margin on others, it would need to consider why such a pattern of pricing is sustainable in the face of competition from other CPs.⁵⁹⁹

9.7 For these reasons, Ofcom concluded that additional tests carried out on individual products, or product groups, on a LRIC basis would not be proportionate, and therefore decided that the margin squeeze test should be applied on the basis of the overall fibre portfolio only.⁶⁰⁰

9.8 Ofcom acknowledged that this fibre portfolio approach departed from the 2013 Recommendation, which stated that NRAs should regulate on the basis of 'flagship products'. However, Ofcom argued that this departure was justified because of the nascent nature of UK SFBB, that BT's rivals offer a similar portfolio of products to BT, and the need to provide BT with flexibility to determine its margins on individual products.⁶⁰¹

TalkTalk's case

9.9 In its Amended Notice of Appeal, TalkTalk stated that Ofcom erred in concluding that additional tests carried out on individual products were likely to be unnecessary and disproportionate.⁶⁰² More specifically, TalkTalk contended that Ofcom had made two errors. First, it claimed that Ofcom erred in the exercise of its discretion in choosing to rely solely on a portfolio-based approach, and in concluding that product-level testing would be unnecessary

⁵⁹⁶ Final Statement, table 5.1, p114.

⁵⁹⁷ Final Statement, paragraph 5.136.

⁵⁹⁸ Final Statement, paragraph 5.137.

⁵⁹⁹ Final Statement, paragraph 5.138.

⁶⁰⁰ Final Statement, paragraph 5.140.

⁶⁰¹ Final Statement, paragraph 7.113.

⁶⁰² TalkTalk NoA, paragraphs 91 & 92.

and disproportionate. Further or alternatively, TalkTalk claimed that Ofcom committed errors of fact in concluding that a portfolio-based test was sufficient to prevent distortive pricing, including in particular its implicit finding that BT could not profitably engage in a targeted price squeeze, and in its assessment of what costs are fixed and common.

- 9.10 TalkTalk asserted that, while a margin test based on LRIC+ at the SFBB portfolio level was necessary and appropriate, this was not sufficient to achieve Ofcom's regulatory aim. This was because it failed to preclude the risk that BT would engage in behaviour that distorted competition in some SFBB segments, ie a targeted price squeeze. As a result, TalkTalk argued that the portfolio-level test should be supplemented with additional product-, or product group-level tests based on LRIC, provided that LRIC is properly estimated.⁶⁰³
- 9.11 TalkTalk criticised each of the five reasons set out in Ofcom's Final Statement in support of its decision not to adopt product-level tests, as summarised at paragraph 9.7 above.
- 9.12 TalkTalk rejected Ofcom's first reason that BT's rivals offered a comparable portfolio of products and argued that other CPs did not, at least not in materially the same proportions as BT. Rather, TalkTalk stated that BT's rivals targeted different customer groups and had adopted different strategies. In particular, TalkTalk operated in what it termed the 'value-conscious' segment.⁶⁰⁴ TalkTalk highlighted various pieces of evidence in support, in particular that it had the lowest ARPU and prices of any of the major retailers.⁶⁰⁵ TalkTalk also set out why it would be very challenging for BT's rivals to expand their offering to match BT's portfolio, in particular that developing the corresponding brands would require significant investment and time.⁶⁰⁶
- 9.13 TalkTalk stated that Ofcom's second reason that there was no evidence that BT's current prices are loss-making did not mean there was no need for *ex ante* regulation to prevent this occurring in future. TalkTalk emphasised that Ofcom gave little weight to this point when considering it in the context of the need for the portfolio-level test.⁶⁰⁷

⁶⁰³ TalkTalk NoA, paragraph 63.

⁶⁰⁴ TalkTalk NoA, paragraphs 56 & 57.

⁶⁰⁵ First expert report of George Houpis, paragraphs 3.10-3.17; First witness statement of James Heaney, paragraph 18.

⁶⁰⁶ TalkTalk NoA, paragraph 58; First expert report of George Houpis, paragraph 3.19.

⁶⁰⁷ TalkTalk NoA, paragraphs 69–72.

9.14 On Ofcom's third reason, that a product-level assessment based on LRIC was likely to be redundant, TalkTalk argued that Ofcom's analysis was flawed because too many of BT's costs were categorised as fixed or common.⁶⁰⁸ TalkTalk stated that this leads to an underestimation of BT's product LRICs and therefore an overestimation of BT's LRIC-based product margins. TalkTalk claimed that when these shortcomings were corrected, BT's product margins were much lower, and that some were actually negative, demonstrating that a product-level test would not be redundant. TalkTalk highlighted two groups of costs in particular.⁶⁰⁹

- (a) There were a number of costs that Ofcom had treated as incremental to BT's total fibre portfolio, but as fixed and common to individual SFBB product groups ('Category A' costs). These costs included [redacted]. TalkTalk estimated that these costs totalled £[redacted] per unit. It claimed there was a reasonable and better case that these costs should also be classified as incremental to individual product groups, as BT could expect to avoid (a proportion of) these costs if it stopped offering any of these product groups.
- (b) There were two cost categories that Ofcom had treated as fixed and common between BT's total fibre portfolio and its other products ('Category B' costs). These were [redacted]. TalkTalk estimated that these total £[redacted] per unit. It suggested that, at least in part, these were likely to be incremental both to BT's total fibre portfolio and to individual product groups, because if the number of SFBB subscribers were to decrease, then these costs would have been likely to fall.

9.15 On Ofcom's fourth reason, that *ex post* competition law may act as a constraint on targeted margin squeezes, TalkTalk claimed that this was insufficient to address the risk of a future weakening of competition with sufficient certainty and speed. It argued that essentially the same considerations recognised by Ofcom as necessitating an *ex ante* test at the portfolio level also applied at the product level.⁶¹⁰

9.16 On Ofcom's fifth reason that BT may not have been able to offset a targeted margin squeeze with high margins on other SFBB products due to competition from other CPs, TalkTalk argued that such a strategy could have been

⁶⁰⁸ As evidence in support of this argument, TalkTalk remarked that it was surprising at first sight that almost [redacted]% of BT's downstream costs were classified as fixed and common, and therefore were excluded from product group LRICs. This was similar to the level for some network activities (contrary to the expectation that costs of retail activities are driven by the number of subscribers), and was inconsistent with evidence from TalkTalk, for whom the proportion of costs considered fixed was only [redacted]%. Source: TalkTalk NoA, paragraph 77.

⁶⁰⁹ TalkTalk NoA, paragraphs 73–82; Second expert report of George Houpis.

⁶¹⁰ TalkTalk NoA, paragraph 83.

profitable for BT and set out several reasons why it considered this was the case. [✂].⁶¹¹

- 9.17 In addition to criticising Ofcom's five arguments, TalkTalk made three further observations on Ofcom's approach.
- (a) It argued that Ofcom's adoption of a portfolio approach was in 'stark contrast' to the 2013 Recommendation, which advocated an approach based on 'flagship products'. TalkTalk claimed that Ofcom's reasons for departing from the 2013 Recommendation (summarised at paragraph 9.9 above) were insufficient.⁶¹²
 - (b) TalkTalk argued that product-based tests would have been consistent with the approach that Ofcom had taken in other regulatory contexts, where it implemented them alongside a portfolio remedy with the specific purpose of addressing more targeted manipulation of prices by BT.⁶¹³
 - (c) Although it recognised that this may not have been a point relied on by Ofcom, TalkTalk argued that it would not be administratively burdensome to specify and monitor a product-level test and for BT to comply with it, in particular because Ofcom and BT had already calculated product-level LRICs at a reasonable level of disaggregation.
- 9.18 TalkTalk concluded by stating that LRIC-based product-level tests were neither disproportionate nor unnecessary. This was because they would retain BT's pricing flexibility and impose limited additional regulatory burden, while guarding against competitive distortion in SFBB at this critical point in its development.
- 9.19 In its subsequent submissions, TalkTalk clarified its proposed remedy.⁶¹⁴ Its primary argument remained that Category A and B costs should properly have been included within the LRIC of individual products/product groups (as set out at paragraph 9.14 above), and that the product-level tests should be instituted at this level, ie what it considers to be the true LRIC level. However, it asserted in the alternative that, if the CMA were to reject its arguments on cost reclassifications, and thereby accept Ofcom's definition of LRIC, the product-level tests should be based on this LRIC plus an equi-proportionate

⁶¹¹ TalkTalk NoA, paragraphs 60 & 61; First expert report of George Houpis, paragraphs 3.28 & 3.29.

⁶¹² TalkTalk NoA, paragraphs 85–87.

⁶¹³ TalkTalk NoA, paragraph 88.

⁶¹⁴ TalkTalk core submission, volume 1, paragraph 74.2; Third expert report of George Houpis, paragraphs 5.1–5.7.

share of Category A costs.⁶¹⁵ In other words, the product-level tests should be based on a form of LRIC+, though this would be less than the specific 'full' LRIC+ that Ofcom had stated it would use for the portfolio test as it would exclude Category B costs.⁶¹⁶

- 9.20 TalkTalk justified the need for the product-level tests at this level, ie above LRIC, on the basis that its operations were focused largely on only one or two product groups. It noted that Ofcom had accepted the need for CPs to be able to make some contribution to their common costs when implementing a LRIC+ test at the portfolio level. TalkTalk argued that the same logic also applied at a product level. This was because its retail proposition was focused on providing only some product groups, rather than the entire SFBB portfolio, and it would have needed to be able to make a contribution to its common costs from these specific products.⁶¹⁷

Our assessment of reference question 1: A product-level test

- 9.21 Before turning to our detailed assessment of the parties' arguments, there are two relevant issues to clarify by way of context.

- 9.22 First, while TalkTalk's broad argument that there should be additional tests at a product level is clear, some uncertainty remains over exactly how an alternative would be implemented in practice. In its Core Submission Volume 2, TalkTalk clarified that it was seeking a grouped product test, and suggested that this should be conducted at the same level of aggregation that Ofcom employed in its provisional assessment. However, TalkTalk stated that it would also be content with another grouping chosen by Ofcom or the CMA.⁶¹⁸ We consider that the question of how these product-level tests would be implemented in practice on an ongoing basis is a key issue. For the purposes of evaluating a number of the arguments put forward by the parties we initially put this issue to one side, but consider it relevant for our assessment of the proportionality of the proposed additional regulation.

- 9.23 Second, TalkTalk stated that product-level tests should be additional to the portfolio level test.⁶¹⁹ As a result, the benefits that this additional layer of

⁶¹⁵ First expert report of George Houpis, paragraphs 4.3-4.6. It was indicated that a test between LRIC and LRIC+ may be appropriate. However, because there was no readily available precedent for what this level should be, Houpis advocated that the additional product-level tests should be based on LRIC. Paragraphs 5.3-5.7 of the third expert report of George Houpis stated that, following disclosure of additional information by Ofcom, the modified approach represented a reasonable intermediate position between LRIC and the full LRIC+ of the portfolio test.

⁶¹⁶ TalkTalk core submission, volume 2, paragraph 74.2.

⁶¹⁷ TalkTalk hearing transcript, p18.

⁶¹⁸ TalkTalk core submission, volume 2, paragraph 30.

⁶¹⁹ Reference question 1 specifically asks whether Ofcom erred 'in deciding not to supplement its portfolio test with a product level test'.

regulation would offer need to be assessed taking into account a context in which TalkTalk and other competitors would have continued to benefit from the protection of the portfolio-level test.

9.24 The rest of our assessment of this reference question proceeds as follows:

- (a) We assess the nature of TalkTalk's proposed additional tests – specifically in relation to its argument that Ofcom misclassified BT's costs – as this potentially has important implications for the evaluation of its proposed remedy.
- (b) We turn to an assessment of the merits of TalkTalk's arguments in favour of additional product-level tests, in the context of BT's ability and incentive to engage in a targeted margin squeeze, and the proportionality of additional regulation to address this risk including the issue of practical implementation.

TalkTalk's proposed additional tests

9.25 TalkTalk's proposed additional product-level tests depend on the assessment of which cost categories should be included within the LRIC of individual product groups. If we were to accept TalkTalk's cost re-classifications, its proposal would result in the introduction of product-level tests based on LRIC. On the other hand, if we were to reject TalkTalk's proposed re-classifications, TalkTalk's proposal would result in the introduction of product-level tests at a level above LRIC. This potentially has important implications for the merits of introducing these additional tests.

9.26 We therefore consider the cost classification issues before turning to the assessment of the merits of TalkTalk's proposal for additional product-level tests. We consider TalkTalk's arguments on Ofcom's classifications of BT's costs in two steps. First, we assess the specific points it raised in relation to Category A and Category B costs; and second, we consider general points that are relevant to our assessment of the treatment of all of these cost categories.

9.27 TalkTalk's argument on Category A costs was that, if these were incremental at the SFBB portfolio level, they would also likely have been incremental at the product level. This was especially the case for products such as Infinity 1 which constituted a large proportion of the SFBB portfolio. TalkTalk asserted that this was because, based on the high-level descriptions of what they consisted of, these costs would likely have scaled with [X]. These would, in turn, ultimately depend on the volume of SFBB subscribers.

- 9.28 We accept, at least in theory, that it is possible that some of these costs might vary with SFBB subscriber numbers. However, it is also possible that they may not. For example, the costs related to [redacted] may simply be a fixed amount that does not vary with the number of subscribers.⁶²⁰ The evidence that TalkTalk put forward in support of its arguments comprised inferences based on the high-level descriptions of these cost categories. It did not put forward any detailed evidence showing that these cost categories varied with sales of individual SFBB products, or even that Ofcom's approach here was implausible.
- 9.29 In its response to our provisional determination TalkTalk argued that if costs were scalable with respect to SFBB customer volumes, then logically they should also scale with customer volumes for product groups.⁶²¹ As noted in paragraph 9.28 it is possible that costs may be incremental at the portfolio level but not at the level of individual products. Although this point of principle was accepted by TalkTalk at its hearing, TalkTalk nevertheless maintained its view that all costs were scalable at the product level.⁶²² For the reasons given in paragraph 9.28, we do not agree.
- 9.30 Of Category B costs, TalkTalk argued that TSO fixed costs included similar types of costs as those categorised as incremental to the SFBB portfolio, such as [redacted], and would therefore also have been expected to vary with subscriber numbers. However, the fact that some of these costs have similar names to other cost categories does not necessarily imply that they should be classified the same way.⁶²³ In this context, Ofcom said in its Defence that TSO fixed costs 'are costs that have no identifiable cost drivers to individual business units and are generally considered by BT as not attributable and common across the business'.⁶²⁴
- 9.31 TalkTalk stated, in its response to our provisional determination, that in Ofcom's draft statement in relation to its Business Connectivity Market Review (BCMR) (dated 22 March 2016), Ofcom recognised that: (a) General BT Overheads, including TSO costs, had causal costs drivers that allowed them to be attributed to specific services; and (b) even where no specific causal cost driver was identifiable, that did not signify that the costs were necessarily fixed and common.⁶²⁵ We consider that TalkTalk's reference to the BCMR emphasised that, at a broad level, there may be different approaches that

⁶²⁰ TalkTalk hearing transcript, pp37–38. At the hearing TalkTalk's experts accepted that, in principle, it is possible that costs that are incremental at the SFBB portfolio level may not be incremental at the product group level.

⁶²¹ TalkTalk response to our provisional determination, paragraph 34.

⁶²² TalkTalk hearing transcript, pp37–38.

⁶²³ For example, some [redacted] costs might vary with subscriber numbers, while others might not.

⁶²⁴ Ofcom defence (TalkTalk Appeal), paragraph 79(a).

⁶²⁵ TalkTalk's response to our provisional determination referred us to Annex 28 of the BCMR.

may reasonably be taken to the treatment of TSO costs. For example, TalkTalk's response referred to the attribution of costs to 'specific services' in relation to the BCMR rather than individual SFBB products. As we conclude in paragraphs 9.28 and 9.35, detailed cost classifications are inevitably difficult and there may be a number of reasonable approaches. But TalkTalk did not specify how Ofcom's approach in the BCMR would support a conclusion that TSO costs should have been treated as incremental at the level of individual SFBB products. We therefore consider that TalkTalk has not shown how Ofcom erred in exercising its discretion in allocating costs for the purposes of setting the Margin Condition.

9.32 TalkTalk also argued that the other Category B costs, ie network costs, could be expected to scale with subscriber numbers. However, these seem to be assumptions or inferences, for example: 'it is possible to assume that at least a proportion of these network fixed costs would also scale in the long run with the size of BT's SFBB business, as they represent traffic backhaul and transportation costs, which would be expected to move proportionately in the long run to the size of BT's SFBB subscriber base'.⁶²⁶ Taking into account that these network costs come from BT's fully allocated cost model, which has been subject to increasing scrutiny both by industry and in various regulatory decisions, TalkTalk has not, in our view, provided a basis for suggesting that Ofcom should not have relied on these classifications and figures.

9.33 We turn next to a consideration of the more general issues that are relevant to the treatment of all of the cost categories discussed above. We consider it particularly relevant that Ofcom's approach built on the detailed analysis of costs that it undertook in the Superfast Broadband Competition Act Investigation. In particular, at its hearing in the TalkTalk Appeal, Ofcom told us that it had had a team of people working on this for around a year and that it had asked very detailed questions about these costs and their key drivers.⁶²⁷ We therefore do not accept TalkTalk's argument that Ofcom essentially took BT's own classification of costs and subjected these to only limited scrutiny.⁶²⁸ We accept Ofcom's evidence that its approach was based on its own thorough assessment.

9.34 In paragraph 33 of TalkTalk's response to our provisional determination it argued that this does not establish that Ofcom's approach was correct. However, we do not rely on this assessment to reach our overall finding, rather this conclusion was in response to TalkTalk's specific claim that Ofcom essentially took BT's own classification of costs and subjected these to only

⁶²⁶ Second expert report of George Houpis, paragraph 3.15.

⁶²⁷ Ofcom hearing transcript (TalkTalk Appeal), pp20–22.

⁶²⁸ TalkTalk core submission, volume 1, paragraph 54.

limited scrutiny. In paragraph 34 of its response, TalkTalk also argued that, in its Competition Act investigation, Ofcom did not examine the issue of whether BT's costs were incremental at the product level. In our view, due to the closely related nature of the issues, it was reasonable for Ofcom to take into account the work it undertook during the Competition Act investigation when considering BT's cost categories and their key drivers.

- 9.35 These cost classification exercises are inevitably difficult and often there may be alternative valid approaches. This is especially the case when each category contains a number of different costs and each individual cost is unlikely to fit neatly into one category. As a result, in practice there may be a number of reasonable approaches open to Ofcom. We agree with Ofcom that such a classification of costs must be based on the data that was available and will necessarily involve the exercise of Ofcom's judgement.⁶²⁹ TalkTalk's evidence, in our view, does no more than highlight possible alternative assumptions based on high level descriptions.
- 9.36 In its response to our provisional determination, TalkTalk argued that, in order for its right of appeal to provide an effective remedy, it must be able to bring its case on a *prima facie* basis that the treatment of costs by Ofcom appeared 'implausible' and was thus 'likely to be in error'. TalkTalk asserted that such a position must be correct in circumstances where it did not have the information available to it to demonstrate that its alternative approach to cost classification was demonstrably better than that chosen by Ofcom. TalkTalk's position was that, if it could be shown that such a *prima facie* case had been made out, the CMA must either (i) investigate further, or (ii) remit the matter back to Ofcom to do the same.⁶³⁰
- 9.37 Having undertaken our own review of the descriptions of the relevant cost categories, which is the key evidence that TalkTalk relied on, we conclude that there is no basis for considering that Ofcom's treatment of these cost categories is 'likely to be incorrect' or 'implausible'. To the extent that TalkTalk highlighted specific issues with the cost categories, we find that on those issues there was sufficient justification for the approach that Ofcom adopted.
- 9.38 We accept that, in certain circumstances, a third party appellant (such as TalkTalk in the present case) may only be able to bring an appeal on a particular point on the basis that Ofcom's approach is 'likely to be in error', without being able to demonstrate that Ofcom was in fact in error, by reason of the appellant's lack of access to the relevant confidential material. We also accept that in such circumstances, an evidential burden may in principle pass

⁶²⁹ Ofcom defence (TalkTalk Appeal), paragraph 77.

⁶³⁰ TalkTalk response to our provisional determination, paragraph 31.

to Ofcom in order to demonstrate the actual basis upon which it arrived at its conclusion. However, notwithstanding this, we do not consider that this is the case in relation to the Ofcom's approach to the cost classifications used for the purpose of the Margin Condition. We have concluded that Ofcom's approach was not 'implausible' (as TalkTalk argued), and was not one that was 'likely to be in error' for the reasons given above.

9.39 In conclusion, we consider that the classification of costs is a matter of regulatory judgement. Whilst it is possible that some elements of the cost categories in question could partially scale with customer numbers, we have come to the view that the approach taken by Ofcom to the classification of costs was one that was perfectly open to it to take. Further, having considered the arguments raised by TalkTalk in its response to our provisional determination, we conclude that, notwithstanding the fact that TalkTalk did not have access to BT's detailed cost classification data, the arguments raised by TalkTalk do not demonstrate that Ofcom's approach was 'likely to be in error' for the reasons given above.

9.40 Accordingly, and for the reasons set out above, we assess TalkTalk's modified proposal for product-level tests based on LRIC plus a share of Category A costs. We consider this cost standard to be a form of LRIC+. In order to distinguish this from the specific 'full' LRIC+ standard that Ofcom specified that it will use in the portfolio test, which also includes Category B costs, we refer to TalkTalk's modified proposed cost standard as 'LRIC(+A)'.

Assessment of TalkTalk's proposed additional tests

9.41 We next consider TalkTalk's arguments in favour of additional product-level regulation. TalkTalk made a number of criticisms of Ofcom's analysis and its reasons for rejecting product-level tests.⁶³¹ In assessing whether TalkTalk's arguments collectively demonstrate that Ofcom erred in deciding not to include product-level tests in the Margin Condition, we consider its points in three steps:⁶³²

(a) The extent to which BT has the ability to engage in a margin squeeze at the product group level, ie to put in place targeted price cuts such that for TalkTalk to compete effectively it must set its prices below its costs.

⁶³¹ [Final Statement](#), paragraph 5.137.

⁶³² TalkTalk NoA, paragraph 90. TalkTalk also assesses the risks of a targeted price squeeze in BT's ability and incentive to engage in this behaviour.

- (b) The extent to which BT has the incentive to engage in this targeted margin squeeze, in particular taking into account the existence of the portfolio level test at LRIC+ and the constraints it faces from its rivals.
- (c) Given the extent of these risks of a margin squeeze emerging, whether it would be proportionate to put in place additional regulation to prevent this, in light of any potential additional regulatory burden this would entail.

- *BT's ability to margin squeeze*

- 9.42 In light of the existence of the portfolio test at the 'full' LRIC+ level defined by Ofcom, BT would only have the ability to margin squeeze with respect to TalkTalk if two conditions hold. First, that TalkTalk operates, and will continue to operate, largely within a specific segment of the SFBB industry; and, second, that BT offers products that directly correspond to this segment, so that in practice it is able to target them with very low margins leaving TalkTalk unable to compete profitably. This assumes BT would still be satisfying the portfolio test by setting higher margins in other SFBB segments where TalkTalk might be less active.
- 9.43 On the positioning of TalkTalk's products, TalkTalk presented a range of evidence to support its claim that its operations were largely focused on what it referred to as the 'value-conscious' segment, in particular that its prices and ARPU were often substantially below those of other retailers. We agree that, at present, TalkTalk tends to compete for customers who are relatively more value-conscious and note that Ofcom accepted that there was a significant differentiation in TalkTalk's positioning.⁶³³
- 9.44 However, we also agree with the comments of Ofcom at its hearing in the TalkTalk Appeal, which questioned how useful the 'value' versus 'premium' segmentation actually was.⁶³⁴ As BT noted in its Statement of Intervention, the SFBB industry is complex with a wide variety of products on offer. Consumers clearly differ in how price-conscious they are. However, their preferences also differ in many other ways. For example, they will differ in relation to broadband usage caps, the extent of Pay TV content, the nature of TV content (eg sport vs other programming), and other bundled products such as supermarket vouchers and computer virus protection. Therefore, we find

⁶³³ Ofcom defence, paragraph 58; Ofcom hearing transcript (TalkTalk Appeal), pp7–8.

⁶³⁴ Ofcom hearing transcript (TalkTalk Appeal), p11.

that in practice, it is not particularly meaningful to segment SFBB consumers into 'value conscious' and 'premium'.⁶³⁵

9.45 Ofcom's view was that TalkTalk would likely have been able to reposition its products to compete across the whole portfolio because it already offered all of the bundle features that were included in BT's premium SFBB offerings.⁶³⁶ However, we share TalkTalk's view that a relevant issue is not whether it could technically offer certain product features, but the 'commercial realism' of reorientating its brand in this way.⁶³⁷ We accept that this could take a substantial amount of time. We therefore find that TalkTalk is, and will continue to be, to some extent, focused on competing for relatively more value-conscious consumers. However, this must be viewed in the context of a market where consumers cannot easily be segmented into 'value-conscious' and 'premium'.

9.46 We turn next to the second issue, which is whether BT's products directly correspond to the 'value conscious' customers that TalkTalk argued it focused on. This would be necessary to enable BT to target effectively these products with very low margins. Ofcom noted that the product-group tests that TalkTalk proposed were based around groups which primarily differed in the upload and download speed of the broadband connection they offered.⁶³⁸ These included:⁶³⁹

- (a) 'Plusnet', a separate brand operated by BT that offers connection speeds of up to 38-76Mb/s without usage limits, that is priced around £16 to £21;
- (b) 'Infinity 1', which offers a connection speed up to 38Mb/s with usage limits, that is priced around £18 to £21;
- (c) 'Unlimited Infinity 1', which also offers a connection speed up to 38Mb/s but without usage limits, that is priced at £23; and
- (d) Infinity 2, which offers a faster connection speed up to 76Mb/s also without usage limits, that is priced at £28.

9.47 BT's products therefore do vary in price from around £16 to £28, with its Plusnet and Infinity 1 products the cheapest. These may therefore be, to some extent, relatively more attractive to those customers who care more

⁶³⁵ Witness statement of James Tickel (TalkTalk Appeal), paragraph 28.

⁶³⁶ Ofcom also asserted that there were no technical features that prevented BT's rivals from offering high speed broadband services.

⁶³⁷ TalkTalk core submission, volume 2, paragraph 7.

⁶³⁸ Ofcom hearing transcript (TalkTalk Appeal), p11.

⁶³⁹ [Final Statement](#), Table 5.1. This table also includes a grouping based on Infinity 3, though in practice, this product is only sold in extremely small volumes. Prices based on April 2015 Compliance Model (Ofcom defence (TalkTalk appeal), volume 4, tab 42), including 20% VAT.

about value for money. However, as discussed above, these do not specifically correspond to so-called 'value-conscious' and 'premium' segments, as this will also depend on customers' preferences regarding brand, download speeds and usage limits.

- 9.48 Moreover, these prices relate only to the SFBB service. In practice, customers will further differ depending on their willingness to pay extra for additional bundle features, such as, Pay TV, access to HD TV content, additional premium Sport content, bundled call packages, network-based answer phone service and caller display on voice calls. Some 'value-conscious' consumers might have a strong preference for a number of these features; similarly, some 'premium' customers might place little or no value on any of them.
- 9.49 Therefore, we find that, while some of BT's products may be relatively more attractive to 'value conscious' consumers than others, none of them readily corresponds to the segment of the SFBB industry on which TalkTalk claimed to focus. This means that it would not be particularly easy for BT to engage in a targeted margin squeeze against TalkTalk by lowering the prices of its more 'value conscious' products and increasing the prices of its 'premium' products. This is because, in practice, it is not possible to classify its products in this clear-cut way. We therefore find that it is unlikely that BT has the ability to engage in a targeted margin squeeze of TalkTalk.
- 9.50 TalkTalk stated in response to our provisional determination that our reasoning was inconsistent with the realities of competition in SFBB.⁶⁴⁰ It agreed that it was not meaningful to divide customers into clear-cut value conscious and premium segments, but argued that price was likely to be the most important dimension of competition and that this distinction was a helpful one analytically. It also stated that it was not necessary for products to 'directly correspond' to the targeted group of customers, but simply that they are 'relatively more attractive'. TalkTalk also stated that 'the fact that those products were not delineated in a clear cut fashion does not significantly reduce BT's ability to engage in a targeted market squeeze'.⁶⁴¹
- 9.51 In our assessment, we accept that BT's products differ in prices and that some might, to some extent, be relatively more attractive to those customers who care more about value for money. However, because of the number of other SFBB features, and the fact that there may be substantial variation in how much customers value these, the link between these products and a value-conscious segment of the market appears relatively weak. While BT's products and the value-conscious segment do not need to correspond

⁶⁴⁰ TalkTalk response to our provisional determination, paragraphs 7–19.

⁶⁴¹ TalkTalk response to our provisional determination, paragraph 19.

precisely for BT to target a segment meaningfully, the extent of the correlation between a segment and products would need to be more significant than the position we observe. Therefore, we do not agree with TalkTalk's points in response to our provisional determination.

9.52 Notwithstanding our findings on BT's ability to engage in a margin squeeze, for completeness we nevertheless assess BT's incentives to do this. In doing so, we assume that, if BT were to attempt to engage in a targeted margin squeeze of TalkTalk, it would most likely do so with its cheaper Plusnet and Infinity 1 products.⁶⁴²

- *BT's incentive to margin squeeze*

9.53 Several of TalkTalk's criticisms of Ofcom's decision to reject product tests addressed Ofcom's analysis as to whether BT had the incentive to engage in a targeted margin squeeze; in other words whether the benefits BT would achieve from this would exceed the costs it would face and therefore whether BT would likely engage in this conduct.

9.54 TalkTalk's two criticisms of Ofcom's analysis of BT's incentives to engage in a targeted margin squeeze related to the two main costs that BT could face if it engaged in this behaviour: those from lost sales; and those from *ex post* competition law. We consider each in turn below.

9.55 First, we consider the costs from lost sales that could result from BT instituting a margin squeeze.

9.56 Given our findings on cost re-classifications, we reject TalkTalk's suggestion that some of BT's product groups currently [REDACTED].⁶⁴³ However, this does not establish that product-level tests would be redundant. This is because BT could in future, in theory, still set very low prices on its relatively more 'value' focused products, with a required offsetting increase in the prices of its relatively more premium products to ensure compliance with the portfolio margin requirement. These price increases on its 'premium' products could then result in lost sales by BT, in particular to Sky which, TalkTalk argued, focused more on competing for these customers.

9.57 TalkTalk argued that BT could avoid the need for an offsetting increase in the prices of some products by [REDACTED].⁶⁴⁴ We accept that this could mitigate the

⁶⁴² This is consistent with the second expert report of George Houpis, paragraph 2.11 that placed particular focus on the margins of Plusnet and Infinity 1.

⁶⁴³ Second expert report of George Houpis, paragraph 2.11, which stated [REDACTED]. This conclusion was based on Houpis' suggested cost-reclassifications, which we have rejected – see paragraph 9.36 above. Without these cost classifications, [REDACTED] estimates of BT's margins at a product group level indicate that these are [REDACTED].

⁶⁴⁴ Third expert report of George Houpis, paragraphs 2.6 & 2.7.

magnitude of these price increases to some limited extent. However, we do not agree that this would substantially eliminate the need for such price increases because it is based on the largely unrealistic assumption that BT may [✂].

- 9.58 In its response to our provisional determination TalkTalk argued that we had misunderstood its evidence on this point, as its calculations showed that BT would be able to engage in a targeted margin squeeze even without reducing its portfolio headroom to zero.⁶⁴⁵ It also argued that an increase in the compliance period arising from the identified error in the BT Appeal would enable BT to reduce its ‘safety margin’ headroom.⁶⁴⁶
- 9.59 However, our assessment is not based on an understanding that BT would have to reduce its portfolio headroom to zero in order to engage in a targeted margin squeeze, rather it is based on the accurate observation that it would have to reduce this *close* to zero; in other words that this reduction would have to be very substantial, which we continue to find is largely unrealistic. Moreover, we do not believe that an increase in the compliance period would affect this finding, as BT is likely to continue to operate with significant portfolio headroom in light of the consequences it could face if it breached the Margin Condition.
- 9.60 The amount of sales BT could lose in this scenario would depend on the size of the offsetting price increase on its ‘premium’ products. This, in turn, would depend on the size of the required reduction in prices on its ‘value’ products. As a result, the larger BT’s current margins on its products, in particular those that are relatively more ‘value’ focused, the greater the costs it would likely face from instituting a targeted margin squeeze.
- 9.61 BT and Ofcom presented various figures on these product margins based on different views on what costs should be covered.⁶⁴⁷ TalkTalk argued that it needed to cover Category A costs to compete effectively. Ofcom disagreed, stating that it was not clear that pricing below LRIC(+A) would distort competition.⁶⁴⁸ Ofcom therefore estimated BT’s margins over its LRIC, on the basis that these provided an indication of whether customers may be incrementally profitable for TalkTalk to compete for.

⁶⁴⁵ TalkTalk response to our provisional determination, paragraphs 23–24.

⁶⁴⁶ This refers to the remedy to the error found in reference question 3(b) of the BT appeal. See Section 4 above.

⁶⁴⁷ Ofcom presents its analysis of BT’s product-level margins at Table 5.1 and paragraphs 5.133 & 5.134 of its [Final Statement](#). TalkTalk presents its analysis of BT’s product-level margins at Table 1 and paragraph 2.11 of the second expert report of George Houpis.

⁶⁴⁸ Ofcom core submission, volume 1, paragraph 24.

- 9.62 Ofcom also presented figures for margins over LRIC at the product level that excluded the costs of BT Sport. This was on the basis that BT Sport costs appeared to be common across BT's products as these would likely be almost unchanged if BT was to cease offering any one product in isolation. These largely related to rights and programming costs.⁶⁴⁹
- 9.63 At its main party hearing, TalkTalk stated that BT Sport costs should be considered incremental, as the amount a broadcaster may pay for rights could vary with the size of its subscriber base, and because rivals may need to offer discounts to match the value offered by BT Sport.⁶⁵⁰ TalkTalk's argument does not persuade us that we should entirely disregard Ofcom's margin estimates as it does not seem to us an unreasonable assumption that BT Sport costs might be largely common across its portfolio. Like Ofcom, we do not seek to resolve the issue of whether the costs of BT Sport are common or incremental to individual products, and we examine therefore the margin estimates put forward by both TalkTalk and Ofcom.⁶⁵¹
- 9.64 TalkTalk's figures show that [redacted].⁶⁵² Ofcom's figures suggest that [redacted].⁶⁵³
- 9.65 Notwithstanding the different views on what costs should be covered, the figures of both parties imply that the size of the offsetting price increase BT would have to make on its 'premium' products, would [redacted]. We also reject TalkTalk's argument that BT could have made such price increases to its premium products with little or no loss of sales. Sky, in particular, is an effective competitor to BT for these customers, so it seems highly likely that BT would lose many sales to Sky if it were to [redacted] the prices of its 'premium' products.⁶⁵⁴
- 9.66 In its response to our provisional determination, TalkTalk argued that BT Sport costs should be treated as incremental, not as largely common.⁶⁵⁵ However, this statement is based on a misunderstanding of our findings because we have not sought to resolve the issue of whether the costs of BT Sport are common or incremental to individual products.⁶⁵⁶ Moreover, as made clear above, because the overall picture we observe is broadly

⁶⁴⁹ Ofcom defence (TalkTalk appeal), Table 3: April 2015 assessment of monthly headroom (including BT Sport) per customer.

⁶⁵⁰ TalkTalk hearing transcript, pp19–20.

⁶⁵¹ Ofcom defence (TalkTalk Appeal), paragraph 72a.

⁶⁵² Second expert report of George Houpis, Table 6. This is based on accepting TalkTalk's argument that it would need to recover Category A costs to have an incentive to compete effectively in SFBB, and also implicitly includes the costs of BT Sport.

⁶⁵³ Ofcom defence (TalkTalk Appeal), Table 3.

⁶⁵⁴ Ofcom hearing transcript (TalkTalk Appeal), pp9–10. At its hearing, Ofcom accepted that, while BT may lose some additional sales to Virgin, the main constraint on BT here would have come from Sky.

⁶⁵⁵ TalkTalk response to our provisional determination, paragraph 25.

⁶⁵⁶ See paragraph 9.63.

consistent irrespective of the treatment of these costs, this does not affect our overall findings.

- 9.67 The second cost types that BT could face from engaging in a targeted margin squeeze are financial penalties, potential legal action and negative publicity resulting from *ex post* competition law enforcement. TalkTalk noted that Ofcom had rejected this argument when deciding to put the portfolio-level test in place. However, in our view, there are important differences here. As Ofcom stated in its Defence,⁶⁵⁷ the existence of *ex ante* regulation at the portfolio level, and the resulting collection of up-to-date revenue and cost data, might enhance the effectiveness of *ex post* enforcement at the product level. In considering the weight to attach to the potential costs to BT of a potential enforcement case on a product-level basis, Ofcom was not, in our view, wrong to take into account that BT would be operating in an environment in which its costs and revenues were being scrutinised regularly and in detail, and in which *ex ante* regulation at a portfolio level was already in place.
- 9.68 TalkTalk also criticised what it argued was Ofcom's reliance in its Final Statement on the observation that BT's historical prices were above LRIC. We agree with TalkTalk that this historical evidence is not particularly informative of the risk of BT engaging in a targeted margin squeeze in future. However, we also recognise that this is not a point on which Ofcom appears to have placed much weight.
- 9.69 In its response to our provisional determination, TalkTalk argued that it was unclear how the existence of *ex ante* regulation at the portfolio level would enhance the effectiveness of *ex post* competition law at the product level.⁶⁵⁸ This was, it argued, because the ongoing data collection did not cover any data below the level of the total portfolio. However, we consider this point to be based on a misunderstanding; the ongoing data collection exercise included the collection of detailed data at the product level. Further, while we recognise that data provided for the purposes of demonstrating compliance with the portfolio-level Margin Condition is provided for that purpose only, we nevertheless deem it relevant when assessing BT's incentives that it is operating in an environment in which its product-level costs and revenues are being scrutinised regularly.
- 9.70 We therefore reject TalkTalk's arguments against Ofcom's assessment of both of the costs that BT would face if it was to engage in a targeted margin

⁶⁵⁷ Ofcom defence (TalkTalk Appeal), paragraph 83.

⁶⁵⁸ TalkTalk response to our provisional determination, paragraph 26.

squeeze. As a result, we find that, in line with Ofcom's conclusions, it is unlikely that BT would have an incentive to engage in such behaviour.

- *The proportionality of additional regulation*

- 9.71 The final question we consider is whether the finding that BT is unlikely to have either the ability or incentive to engage in a targeted margin squeeze is sufficient to justify Ofcom's conclusion that it would not be proportionate to place these additional restrictions on BT. Specifically, we consider TalkTalk's claim that these additional product-level tests would not be particularly administratively burdensome to implement.⁶⁵⁹ TalkTalk's case is that it could still be proportionate to introduce these tests to tackle even only a small risk of a margin squeeze occurring, if the regulatory costs of doing so are very small.
- 9.72 Ofcom has previously undertaken calculations of BT's margins on a product-group level on more than one occasion and its model includes the functionality to run these in future. This suggests to us that the administrative burden of these would be low.⁶⁶⁰ In response to TalkTalk's claim that additional product-level tests would not be burdensome to implement, Ofcom stated that this was not a consideration that it had relied on.⁶⁶¹ At its hearing, Ofcom stated that, even if additional regulation were relatively light, it should not be put in place unless proportionate to do so. It added that regulation should only be imposed if it is absolutely necessary and goes no further than is required.⁶⁶²
- 9.73 Our view is that, in deciding whether or not it is proportionate to extend the scope of the VULA margin regulation to a product level, it is informative to have regard both to the benefits that this offers in addressing potential risks to competition and the regulatory costs in potentially restricting firms' behaviour and creating an administration burden. We find that it is unlikely that BT will have either the ability or incentive to engage in a targeted margin squeeze of TalkTalk, but do not rule out this risk entirely. As a result, while we consider the benefits of this additional regulation would be limited, we do think it is still relevant to consider TalkTalk's argument and weigh these benefits against the regulatory costs these product-level tests would involve.

⁶⁵⁹ TalkTalk NoA, paragraph 89.

⁶⁶⁰ Ofcom defence (TalkTalk appeal), Tables 2 and 3, included an analysis of product margins based on Ofcom's indicative assessment and its April 2015 assessment. Product-level margins were calculated in Ofcom's April 2015 compliance model.

⁶⁶¹ Ofcom defence (TalkTalk Appeal), paragraph 89.

⁶⁶² Ofcom hearing transcript (TalkTalk appeal), pp14–15.

- 9.74 In its Statement of Intervention, BT stated that it had over 100 different SFBB propositions, with further options for customers to purchase additional features. It also noted that there had recently been a number of changes to the structure of its retail propositions, so that it was not clear if additional tests might be needed to reflect those changes.⁶⁶³ In our view, this implies that, despite the fact that Ofcom has previously managed to undertake product-level margin calculations, there could be substantial practical difficulties in operating a product-based test on an ongoing basis, even if products are amalgamated into a number of broad groupings as TalkTalk suggested. This is because of the substantial uncertainty that this could create for BT relating to how any changes to its retail propositions could affect its compliance with the tests, which may limit its flexibility to introduce innovative retail offerings. For example, if BT were to introduce a new SFBB product, it might be unclear into which product group it should be incorporated for the purposes of the Margin Condition. In addition, if BT were to alter its existing SFBB products, it would be unclear if that would change their allocation and into which alternative groups they should be classified instead.
- 9.75 In its response to our provisional determination, TalkTalk said that it was not obvious how it could be unclear into which group any new BT product would fall and that, in any event if necessary, a new category could be introduced.⁶⁶⁴ However, in light of the complexity of firms' SFBB products and the rate of innovation and change in this industry, we believe that there is a risk that additional product tests would create regulatory uncertainty for BT. Moreover, while new categories could be introduced if necessary, uncertainty over if and how this would happen, and time delays in implementation, could reduce BT's incentives to innovate.
- 9.76 A further point relevant to the assessment of the regulatory costs of these additional product tests is that, because these would be at a LRIC(+A) level, ie above LRIC, they would also reduce BT's flexibility to recover its common costs across its product portfolio as it sees fit. Specifically, at its hearing in the TalkTalk Appeal, Ofcom explained that this would remove BT's flexibility over the recovery of its Category A costs, which are approximately £[redacted] on average per SFBB subscriber.⁶⁶⁵ We agree with Ofcom that, where possible, it is preferable to give firms flexibility over their pricing and common cost recovery across their product portfolios.⁶⁶⁶ The fact that TalkTalk's proposed

⁶⁶³ Witness statement of James Tickel (TalkTalk Appeal), paragraphs 23 & 14.

⁶⁶⁴ TalkTalk response to our provisional determination, paragraphs 35–37.

⁶⁶⁵ Ofcom hearing transcript (TalkTalk Appeal), p5, line 24.

⁶⁶⁶ [Final Statement](#), paragraph 5.127. Ofcom argued that 'the total fibre portfolio approach provides BT with the flexibility to determine the margins on individual products within the portfolio. We consider that flexibility is particularly desirable'.

tests would restrict this flexibility further weighs against implementing this additional regulation.

Our determination on reference question 1: A product-level test

- 9.77 Based on our assessment above, we find that Ofcom did not err in deciding not to supplement its portfolio level test with a product-level test. We also conclude that Ofcom took utmost account of the 2013 Recommendation and had sufficient reason for departing from it.
- 9.78 We therefore determine that Ofcom did not err in relation to reference question 1.

10. TalkTalk Appeal: Reference question 2: Call revenues

Introduction

- 10.1 By reference question 2, TalkTalk alleged errors by Ofcom in its treatment of call revenue. It argued that Ofcom erred in not adjusting the EEO standard to take into account what it said was the fact that BT benefitted from call revenues across its customer base which could not be replicated by a competitor. Specifically, TalkTalk alleged that, when calculating the revenues of an adjusted EEO, Ofcom erred in deciding not to use BT's call revenues for newly acquired customers.
- 10.2 Call revenues consist of both 'package' fees and 'out of package' (OOP) charges, which can be described as follows:⁶⁶⁷
- (a) Package fees are earned when customers pay extra for a particular call package (eg unlimited calls to certain telephone numbers at all times of the week) or certain call bolt-ons (eg paying a monthly fee to reduce the cost of international or mobile calls).
 - (b) OOP revenues are earned when customers make fixed landline calls outside those included in their call package.
- 10.3 The products which generate call revenue are generally sold by CPs as part of a larger bundle, such as a triple-play SFBB service. As an individual component of this larger service, CPs adopt different commercial strategies

⁶⁶⁷ [Final Statement](#), paragraph 6.82. This does not include line rental revenues (assumed to be supplied using Openreach's Wholesale Line Rental product in the margin control).

with regard to their call revenue products, in order to maximise profit from the overall bundles.

Ofcom's approach

10.4 Ofcom implemented an adjusted EEO standard as part of the Margin Condition.⁶⁶⁸ The framework which Ofcom applied when considering potential adjustments was a two-step test where both aspects needed to be met before an adjustment was made:⁶⁶⁹

(a) Is there evidence that BT's costs/revenues materially differ from those of other operators?

(b) If so, is it likely that other operators could match BT's costs/revenues?

10.5 In response to the Consultation, TalkTalk contended that BT had, as a result of its incumbency, a base of legacy customers who made a very high volume of calls and did not tend to switch provider. TalkTalk argued that rivals were unable to attract these customers (ie they were effectively non-contestable) and it was therefore wrong to include these customers when considering the VULA margin that an effective rival required.⁶⁷⁰

10.6 TalkTalk proposed two alternative approaches at that time, which were:⁶⁷¹

(a) Ofcom could specify the expected level of usage in minutes per month; or

(b) Ofcom could include call revenue for BT SFBB customers who had been with BT for eight years or less. This was the period of time which TalkTalk considered competition to have been active in the broadband market. It contended that this would remove the impact of inert legacy customers who were not accessible to other providers, whilst minimising any uncertainty for BT since it had the data required to implement this.

10.7 In the Final Statement, Ofcom considered evidence related to the call revenues associated with BT's customers and, in particular, noted BT's statements that:

[redacted] had been BT customers for longer than 8 years, [redacted]. It is therefore misleading to argue that all customers who have been with BT longer than 8 years are 'non-contestable'.

⁶⁶⁸ [Final Statement](#), paragraph 5.33.

⁶⁶⁹ [Final Statement](#), paragraph 6.57.

⁶⁷⁰ [Final Statement](#), paragraph 6.84.

⁶⁷¹ [Final Statement](#), paragraph 6.87.

Average call revenues [redacted] were [redacted] those of the alleged cohort of 'contestable' customers (ie those that have been with BT less than 8 years) that TalkTalk argued could be used to implement an adjustment ([redacted]), with [redacted]. As such, it is not correct that customers with the highest call revenues are non-contestable.⁶⁷²

- 10.8 Ofcom recognised TalkTalk's argument that there might be a material difference in call revenues between BT and other operators.⁶⁷³ However, Ofcom stated that it was neither clear that BT's higher call revenue was necessarily a result of its incumbency position, nor that it was an advantage which other operators would be unable to match. In particular, Ofcom considered that BT might be positioning itself in the market to attract higher call value customers, as evidenced by the fact that [redacted].⁶⁷⁴ Ofcom also noted that [redacted].⁶⁷⁵
- 10.9 In addition, Ofcom examined call revenue data for customers leaving BT, and found this to be relatively close to that of BT's overall SFBB base [redacted]. Ofcom interpreted this as indicating that other CPs were not struggling to compete for a subset of BT's customers that account for high call revenue, as those who were leaving, presumably for another operator, had similar call revenue to those within BT's overall SFBB base.⁶⁷⁶
- 10.10 On this basis, Ofcom considered that there was insufficient evidence to conclude that BT's higher call revenues stemmed from a group of customers that were not contestable. It did not therefore consider it appropriate to make an adjustment to call revenues.⁶⁷⁷
- 10.11 Ofcom concluded that the most appropriate figure to use for call revenue was the average revenues earned from SFBB customers over the past six months, including both package fees and OOP calls.⁶⁷⁸

⁶⁷² Final Statement, paragraph 6.88.

⁶⁷³ Final Statement, paragraph 6.92.

⁶⁷⁴ Final Statement, paragraph 6.93.

⁶⁷⁵ Final Statement, paragraph 6.93.

⁶⁷⁶ Final Statement, paragraph 6.94.

⁶⁷⁷ Final Statement, paragraph 6.95.

⁶⁷⁸ Final Statement, Annex 3, paragraph A3.17.

TalkTalk's case

10.12 TalkTalk contended that Ofcom's decision not to make an adjustment to BT's call revenues was an error which could not be supported in light of the evidence provided by Ofcom itself in the Final Statement.⁶⁷⁹

10.13 In particular, TalkTalk stated that the fact that incumbency advantages may explain only part of the higher call revenues that BT enjoyed was not sufficient to reject the need for an adjustment of any kind.⁶⁸⁰

10.14 TalkTalk restated some of the evidence which Ofcom had taken into account during the Consultation, particularly emphasising that:⁶⁸¹

- (a) BT's call revenues were [REDACTED];
- (b) call revenues for recently acquired customers were [REDACTED]; and
- (c) customers churning away from BT in 2012/13 had [REDACTED].

10.15 The available data was also presented in tabular form:⁶⁸²

Table 2: BT calls ARPU by customer group (£ per month per subscriber)

[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]

Source: First expert witness report of Martin Duckworth, Table 1.
[REDACTED].

10.16 TalkTalk stated that a clear segmentation of customer value around the 8-year mark was likely to be an oversimplification, but argued that it was sufficient to have 'some positive correlation' between customer life times and average call revenues per customer for there to be an incumbency effect.⁶⁸³ TalkTalk noted that Ofcom had recognised that 'call revenues appear to be [REDACTED].'⁶⁸⁴

⁶⁷⁹ TalkTalk NoA, paragraph 102.

⁶⁸⁰ TalkTalk NoA, paragraph 102.

⁶⁸¹ TalkTalk NoA, paragraphs 104.1–104.3.

⁶⁸² The 'New customers' figures only include those actually joining BT's network, ie they exclude any BT internal upgraders.

⁶⁸³ TalkTalk NoA, paragraph 105.

⁶⁸⁴ [Final Statement](#), paragraph 6.50.

10.17 TalkTalk further argued that this data demonstrated directly that using the average of BT's overall customer base did not appropriately reflect the characteristics of those customers that BT and competing CPs were seeking to acquire at the time. This was on the basis that, even for BT, revenues from recently acquired customers were [redacted].⁶⁸⁵

10.18 Therefore, although Ofcom generally uses cost input data from BT's overall customer base, TalkTalk argued that Ofcom should make an adjustment where that data is not reflective of the customers that BT and rivals are currently competing to acquire.⁶⁸⁶

10.19 TalkTalk rejected three of Ofcom's specific arguments as set out in the Final Statement:⁶⁸⁷

(a) BT new customers [redacted] competing CP averages ([redacted])⁶⁸⁸ for TalkTalk). TalkTalk argued that this observation was:

irrelevant to the question of whether an adjustment for call revenues is necessary. There may be differences in ARPU [Average revenue per user]⁶⁸⁹ between CPs on the basis of commercial strategy, discounting etc. However, where *in addition* there is a marked difference in call revenues per subscriber *within BT's own customer base*, related to length of tenure, a characteristic that cannot be fully matched by competing CPs as recognised in the ACL adjustment, it is nevertheless necessary to make some adjustments to the assumed call revenues. Otherwise, BT can set prices for new customers which would not be profitable – even for BT – for those new customers and which would in effect under Ofcom's margin squeeze test be subsidised by higher call revenues from the legacy customer base' [original emphasis]

(b) Virgin Media average (£[redacted])⁶⁹⁰ [redacted] BT average (£[redacted]).[redacted]:

does not address the point that BT enjoys a revenue advantage from its legacy customer base that cannot be

⁶⁸⁵ TalkTalk NoA, paragraph 107.

⁶⁸⁶ TalkTalk NoA, paragraph 109.

⁶⁸⁷ TalkTalk NoA, paragraphs 112–115.

⁶⁸⁸ First expert report of Martin Duckworth, Table 2, p18.

⁶⁸⁹ TalkTalk referred to ARPU here, which is equivalent to the call revenue per customer concept on which its appeal is based.

⁶⁹⁰ First expert report of Martin Duckworth, Table 2, p18.

matched by other rivals such as [redacted] (or by BT in respect of its own new customers);

(c) BT churners (£[redacted]) [redacted] BT SFBB average (£[redacted]). TalkTalk argued that this observation was:

of limited relevance. SFBB customers churning away from BT in 2013/14, who by definition were early adopters of SFBB, make up only a limited proportion of the addressable market. There is no reason why they should be representative of that wider addressable market, which is made up of a mixture of churning customers and customers purchasing an SFBB product (or any fixed line product) for the first time.

10.20 TalkTalk also presented the data on competing CPs' call revenues, as shown below in Table 3.

Table 3: Call ARPUs by CP (£ per month per subscriber)

[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]

Source: First expert witness report of Martin Duckworth, Table 2.
*This average only reflects the period June 2013 to March 2014.

10.21 TalkTalk's proposed alternative involved using BT's call revenues (and associated costs) for only the most recently acquired customer cohort, rather than BT's entire SFBB base as the current guidance states. This is because TalkTalk considered that this would have been consistent with using the prices related to new customers and would have been most likely to reflect the actual economics of new customers faced by BT and competing CPs. At the same time, it would have addressed any concerns regarding difference in revenue attributable to commercial strategy and should have posed no greater practical difficulty than using data relating to all SFBB customers.⁶⁹¹

10.22 On the basis of its arguments above, TalkTalk contended that Ofcom committed either an error of fact or an error in the exercise of its discretion, through insufficient investigation of the evidence, in making no adjustment in call revenues.⁶⁹²

⁶⁹¹ TalkTalk NoA, paragraphs 119 & 120.

⁶⁹² TalkTalk NoA, paragraphs 121 & 122.

Our assessment of reference question 2: Call revenues

10.23 TalkTalk's reference question 2 included two separate arguments regarding Ofcom's interpretation of the evidence base on call revenues for different BT customer types. These two arguments were:

- (a) **Adjustment due to incumbency advantage** – If BT has an unmatched advantage due to its position as the legacy provider, this advantage should be removed under the adjusted EEO standard.
- (b) **Representative of new customers** – The Margin Condition is focused on new customers, and so call revenues should be based on the latest cohort of customers. The current approach is based on using an average call revenue from all BT SFBB customers, and is therefore inconsistent with other areas of the Margin Condition.

10.24 TalkTalk also made a third argument that Ofcom erred in its discretion by failing to investigate sufficiently whether an adjustment to call revenues was appropriate.

10.25 As discussed in paragraph 10.21 above, TalkTalk proposed an alternative approach which used call revenues and costs from the latest cohort of customers and estimated that the impact of this would have been a [%] ⁶⁹³ on BT's monthly headroom. We consider it relevant that this calculation was based on TalkTalk's preferred alternative and therefore excluded BT upgraders. Upgrading customers are included elsewhere in the Margin Condition. The equivalent call revenue figures for all new BT SFBB customers, ie including customers new to BT and internal upgraders, are not known.

10.26 Since upgrading customers make up [%] ⁶⁹⁴ of all new BT customers, their inclusion [%]. For example, if upgrading customers generated call revenue in line with the SFBB average base, this would imply that the difference in VULA margin would be [%] from TalkTalk's estimate of £[%] to £[%]. ⁶⁹⁵ We also note that TalkTalk's estimate was based on 2013/14 figures. The call revenue

⁶⁹³ First expert report of Martin Duckworth, paragraph 7.3.

⁶⁹⁴ Ofcom defence (TalkTalk appeal), paragraph 112.

⁶⁹⁵ Based on using a weighted average of [%] of £[%] (new to BT customers) and [%] of £[%] (upgraders based on SFBB total base) = £[%]. This is a £[%] difference in call revenue from the overall base instead of the £[%] figure quoted by TalkTalk. Using the [%] percentage profit margin on this which TalkTalk used, this would imply an estimate of £[%]. TalkTalk figures from First expert report of Martin Duckworth, paragraph 7.3.

estimates for 2014/15 show [redacted] impact than TalkTalk's estimate at £[redacted] (excluding BT upgraders).⁶⁹⁶

Adjustment due to BT incumbency advantage

- 10.27 First, we do not see that there is an underlying principle which explains why a legacy incumbent would be likely to have such an unmatched advantage in call revenues. This contrasts to other areas, in particular ACL, where customers that have a low switching propensity are by definition more likely to be with the legacy incumbent operator. Nevertheless, we assess the evidence TalkTalk relied on as suggestive of an incumbency advantage and the different interpretations by TalkTalk and Ofcom of the relevant data.
- 10.28 It appears to be common ground between the parties that BT's overall customer base has a [redacted] call revenue figure [redacted]. However, the parties differed in their views of whether there is sufficient evidence that these [redacted] call revenues are due to a legacy incumbency advantage and therefore whether this would lead to an advantage which was likely to be unreplicable by an EEO.
- 10.29 The issues raised by TalkTalk in this reference question about an alleged incumbency advantage were considered by Ofcom during the Consultation and Ofcom's arguments have not evolved substantially since the Final Statement. Also, the evidence and arguments on which TalkTalk relied on this point were available to Ofcom at the time it prepared its Final Statement. We therefore consider whether TalkTalk has demonstrated that Ofcom erred in its assessment of the available evidence when coming to its decision.

Ofcom's evidence base

- 10.30 TalkTalk's criticisms of Ofcom's evidence base were the following:⁶⁹⁷
- (a) Ofcom observed that [redacted]. TalkTalk argued that although this showed that there may be other differences (eg commercial positioning), it did not preclude that some of the difference [redacted] was due to incumbency.
 - (b) Ofcom observed that [redacted]. TalkTalk asserted that [redacted] may have unreplicable advantages of its own, and so made a poor comparator here.

⁶⁹⁶ Annualised data for 2014/15 as shown in the First expert report of Martin Duckworth, p17, Table 1. The difference between 'new customers' (£[redacted]) and 'SFBB base' (£[redacted]) is £[redacted], which (assuming the same profit margin) implies £[redacted] impact on BT's headroom.

⁶⁹⁷ TalkTalk core submission, volume 1, paragraph 66.

(c) Ofcom observed that customers leaving BT had similar call revenues to BT's overall base. TalkTalk argued that customers leaving BT were only a small segment of the market, and were also likely to have been early adopters. Therefore, their behaviour was unlikely to be representative of the wider market.

10.31 We consider it relevant that the first two of these arguments (ie (a) and (b) above) are based on observations of differences between the call revenue of CPs. In our view, evidence which relies on a comparison between CPs is not informative when considering a potential incumbency advantage in the specific case of call revenues. This is because of the difficulty of isolating any differences in revenue between CPs which result from commercial differences in the treatment of a small part of the overall bundle. For example, a CP may choose to have a lower line rental charge but higher prices for calls. This would result in the same revenue generation across the bundle but lower call revenue. Such a difference in call revenue would not be informative in considering whether BT had an unmatchable incumbency advantage; it would simply reflect a different pricing structure.

10.32 We therefore focus our assessment on the discussion about the implications of observable differences in BT's own customer data. This is consistent with the arguments of both Ofcom and TalkTalk in this appeal that give greater weight to the extent to which BT's own performance data might demonstrate an incumbency advantage. For example, TalkTalk told us that its case did 'not rest on differences in achieved call revenue between different operators'.⁶⁹⁸ Similarly, at its core submission hearing, Ofcom emphasised the churn data ((c) above), stating that 'this was the key fact which [...] suggests that BT did not enjoy an incumbency advantage in relation to call revenues'.⁶⁹⁹

10.33 In order for BT to have an unmatchable advantage in call revenues due to its legacy position, it would need to have a group of customers that are difficult or impossible for competitors to win, and who are generating a higher than average value of call revenues. In this case, the call revenues in the Margin Condition would be higher than those which an EEO could expect to win. In our view, if other CPs are winning a 'fair share' of BT's high call revenue customers, this is consistent with a view that there is no incumbency advantage.

10.34 TalkTalk challenged Ofcom's reliance on call revenue data in respect of customers leaving BT, ie churning customers, on the basis that these customers would not be a good measure of what a hypothetical EEO would

⁶⁹⁸ TalkTalk hearing transcript, p53, lines 14–15.

⁶⁹⁹ Core submission hearing transcript (TalkTalk Appeal), p50, lines 6-8.

be able to win in the market. It argued that this was because their behaviour was unlikely to be representative of customers in the wider SFBB market segment, particularly as this developed in the future. In our view, this argument is relevant to TalkTalk's position that BT's overall base, or indeed BT's churning customer set, was not representative of the new cohort on which the Margin Condition was focused. We assess the merits of this argument in the next section.

10.35 In summary, making an adjustment to the EEO standard would imply that BT's call revenues, as assumed within the Margin Condition, are not likely to be replicable by a hypothetical competitor in winning new customers. In coming to its conclusion Ofcom placed weight on the call revenues of BT's churning customer base which we agree is a relevant consideration in assessing whether BT's legacy incumbency is likely to lead to an unmatchable advantage here. Therefore, we consider that TalkTalk has not shown Ofcom to have incorrectly used the evidence when making its decision.

Representative of new customers

10.36 TalkTalk noted that the Margin Condition was focused on new customers and argued that call revenues should therefore be based on the latest cohort of customers. The current approach is based on using an average call revenue from all BT SFBB customers.

10.37 Although the Margin Condition is focused on the latest cohort of acquired customers, a number of the cost lines in the Margin Condition use averages from a larger group, particularly from BT's total SFBB customer base, to act as a proxy. Ofcom saw this as having practical benefits with regard to accessing the data, as well as reducing volatility.⁷⁰⁰

10.38 However, it appears to be common ground between the parties that where the BT base of SFBB customers is not representative of the new BT cohort, then it should not be used as a proxy. We therefore consider whether there is evidence that the BT base of SFBB customers is not representative of the new cohort's call revenues.

10.39 TalkTalk and Ofcom differed in their interpretation of whether the evidence shows that BT's base is unrepresentative for call revenues. In particular, in 2013/14, BT's new SFBB customers (excluding upgraders) generated [£x] of call revenue compared with the average SFBB base for BT of £[£x]. TalkTalk

⁷⁰⁰ Ofcom hearing transcript (TalkTalk appeal), p36.

characterised this as BT's new customers' call revenue being [redacted] BT's average.

10.40 As discussed in paragraph 10.26 above, the inclusion of BT upgraders could [redacted] the implied difference in call revenues between new and existing BT SFBB customers. Ofcom therefore contended that without this additional data, it was not clear that the total SFBB base was unrepresentative of the new cohorts.

10.41 TalkTalk made two additional points, namely the following:

(a) Since TalkTalk considered that BT upgraders should have been excluded from the appropriate measure of call revenue for the new cohort, the data provided above was sufficient to show that the SFBB base was not representative of this new cohort.

(b) Even if BT upgraders were included, [redacted].⁷⁰¹

10.42 In summary, there appears to be a two-step process in examining the evidence for whether the call revenue for BT's SFBB base appears unrepresentative of the latest cohort:

(a) To consider whether BT upgraders should be included in the assessment.

(b) To consider whether there is sufficient evidence that BT's SFBB base is not representative of its new cohorts with regard to call revenues.

Inclusion or exclusion of BT upgraders

10.43 TalkTalk argued that BT upgraders were less contestable than those switching from alternative providers. This was because of a combination of the level of direct access available to other CPs, such as, direct marketing channels, as well as the level of engagement that the customer had with the market; that is, they may not have considered alternative CPs at the point of upgrading.

10.44 Ofcom considered it plausible that when a customer was deciding to upgrade to SFBB they would have considered other operators as well as their existing one. Ofcom also highlighted that the EEO principle would assume that the hypothetical competitor also had a set of SBB customers which it could seek to upgrade to SFBB.

⁷⁰¹ TalkTalk core submission, volume 2, paragraph 24.

10.45 We would consider that, in a hypothetical case where a customer is offered new SFBB services of equivalent value by multiple CPs, there would be a natural bias to remain with the existing supplier. This could be due to a combination of loyalty, trust, and the inconvenience/risks associated with switching.

10.46 However, this effect is common among different services. Competitors can and do win other providers' customers (within SFBB, SBB, and other services), and competition is predicated on such a possibility. Therefore, although there will clearly be degrees of how contestable a particular customer is, it is not clear that BT upgraders should be considered sufficiently uncontestable as not to be included as part of the Margin Condition.

10.47 Also, the definition of new cohort used throughout the rest of the Margin Condition includes BT's upgraders. Therefore, the exclusion of upgraders when assuming call revenues would be inconsistent with the rest of the Margin Condition without clear evidence to support such an approach.

Evidence of BT's base being unrepresentative of its new cohorts

10.48 If upgraders are included as part of the new cohort, the estimated call revenues of this new cohort is unclear, [REDACTED]. For example, as we noted in paragraph 10.26 above, if the upgraders had call revenues in line with the SFBB average base, this would imply that the difference in VULA margin would be [REDACTED] from TalkTalk's estimate of £[REDACTED] to £[REDACTED], and this would [REDACTED] further using data from the latest year.⁷⁰²

10.49 TalkTalk asserted that [REDACTED] if BT upgraders are included.⁷⁰³ However, we do not share TalkTalk's view that it is reasonable to make such an assumption on the available data. At most, the data shows that call revenues are [REDACTED].

10.50 In its response to our provisional determination, TalkTalk accepted the point made at paragraph 10.48 that, if upgraders have the same call revenue as the overall SFBB base, then the average of upgraders and new customers will have a 'blended' revenue closer to that of BT's SFBB base than new customers alone. However, TalkTalk went on: [REDACTED]. TalkTalk stated that neither the CMA nor Ofcom had presented evidence or reasoning as to why [REDACTED].⁷⁰⁴ TalkTalk therefore contended that it had demonstrated that Ofcom had committed a *prima facie* error in failing to investigate further what impact BT's

⁷⁰² The 2014/15 estimated data shows BT's externally acquired customers to have call revenue of £[REDACTED], whilst BT's overall base was £[REDACTED]. Using the same share of upgraders ([REDACTED]%), and the same margin generated on call revenues ([REDACTED]%) would indicate an impact on BT's VULA margin of £[REDACTED].

⁷⁰³ TalkTalk core submission, volume 2, paragraph 24.

⁷⁰⁴ TalkTalk's response to our provisional determination, paragraph 52.

upgrader data would have had and, as a result, Ofcom had not provided a robust justification for its decision to use a proxy.

- 10.51 We disagree. Even in the absence of specific call revenue data on upgrading customers, it is not apparent that there is any good underlying reason to believe that BT's entire SFBB base would have a materially different call revenue than its new customers (including upgraders).
- 10.52 Furthermore, there are likely to be benefits from the use of BT's SFBB base as a proxy for the monthly call revenue of the new customer cohort compared with the alternative proposed in TalkTalk's appeal of using monthly cohort data. Ofcom stated that using monthly cohort data for call revenue could result in 'volatility issues or other quirks'.⁷⁰⁵ We agree with Ofcom, and consider that there would be some advantages to using BT's base to represent the expected call revenue a customer would generate each month for their ACL. Even in the absence of any sampling errors, using monthly cohort data could result in less appropriate figures, for example the following:
- (a) Volatility or seasonality could result in any short-term changes being maintained for a customer's entire ACL, when a longer-term approach would average these out and hence be more representative.
 - (b) Only using the monthly cohort would rely on a substantial proportion of customers' figures being 'grossed up', or otherwise extrapolated from partial data since the customers would be joining part way through a month. This could result in inaccuracies in the final figures used.
 - (c) The month that customers switch their telecoms provider may not be representative of their ongoing behaviour, particularly if there was any disruption that took place during the switch. Therefore this would not be representative of their ongoing call revenue over their ACL.

10.53 Therefore, we consider that Ofcom's use of BT's SFBB base to represent the monthly call revenue of the new customer cohort (across its ACL) is reasonable in this case.

Sufficiency of investigation

10.54 TalkTalk contended that Ofcom erred by failing to sufficiently investigate whether an adjustment to call revenues was appropriate.

⁷⁰⁵ Core submission hearing transcript (TalkTalk appeal), p53.

- 10.55 Ofcom denied this and stated that, having been alerted to a concern by TalkTalk during the Consultation, it had provided stakeholders with an opportunity to comment by publishing an addendum to the Consultation. In response to TalkTalk's submission, Ofcom had then gathered additional data both from BT, including the split between those who had been with BT for more than eight years and those who had been with BT for less than eight years and new/churning customers, as well as from other CPs, such as Virgin Media, Sky, TalkTalk, and EE.⁷⁰⁶
- 10.56 We note that when investigating the call revenues of BT's new customers, Ofcom did not gather figures from BT's internal upgraders. Ofcom highlighted that TalkTalk's argument, that BT's entire SFBB base was not representative of the new cohort, was not made prior to the appeal and it therefore had no reason to collect data on upgraders.
- 10.57 Ofcom must assess the extent of the assessments that it needs to carry out to achieve its objective. In doing so, it has a wide margin of appreciation. In the specific context of designing an *ex ante* control, Ofcom is required to balance the extent of investigation it performs against the practical constraints of producing a control within a reasonable time period. This prevents an exhaustive interrogation of all possible aspects, and its general focus will be on the most material and/or contentious areas. Ofcom must act reasonably in deciding what further investigation is necessary in that context.
- 10.58 In our view, Ofcom acted reasonably in the present case, and it was not required to call for specific evidence on call revenue data on upgrading customers. Ofcom's primary focus was on its analysis of TalkTalk's stated concerns relating to a possible incumbency advantage. As we have concluded above at paragraph 10.53, it is not apparent that there is any good underlying reason to believe that BT's entire SFBB base would have a materially different call revenue than its new customers (including upgraders); nor did TalkTalk advance an argument before Ofcom that there was. In our judgement, Ofcom was entitled to reach the conclusions that it did without calling for such further evidence, and its level of investigation was reasonable.

TalkTalk's proposed alternative approach

- 10.59 TalkTalk proposed an alternative approach which used call revenues and costs from the latest cohort of customers. Since this still relied on BT customer data, it has the advantage of ensuring that any differences between

⁷⁰⁶ Ofcom defence (TalkTalk appeal), paragraph 118.

the CPs which result from commercial strategy decisions are not inappropriately removed. TalkTalk's preferred approach was to exclude BT's internal upgraders, although it noted that an alternative approach would be to include them.⁷⁰⁷

- 10.60 Beyond its in-principle arguments for why this approach was less appropriate, Ofcom highlighted 'practical difficulties' associated with using new cohort data, as well as idiosyncrasies in the data itself. It did not elaborate on what these might consist of, beyond concerns that this approach could lead to greater levels of volatility.⁷⁰⁸
- 10.61 As discussed in paragraph 10.47 above, an approach to call revenues that excluded internal upgraders would appear to be inconsistent with the treatment of other revenues/costs within the VULA margin. In particular, such an approach would result in call revenues being treated differently from other parts of the bundle to which it is closely linked, such as line rental.
- 10.62 We also consider it significant that a figure based on the new cohort would be much more susceptible to volatility and hence could result in unforeseeable breaches by BT. It would also appear harder to measure call revenue accurately. Even if the usage data was easily extractable from BT's systems, it appears very likely that it would require the grossing up of partial months, increasing the risk that the data would not be representative of the customer's general behaviour (as discussed in paragraph 10.52).

Our determination on reference question 2: Call revenues

- 10.63 Based on our assessment above, we determine that Ofcom has not erred in fact or in the exercise of its discretion when deciding not to use BT's call revenues for newly acquired customers when calculating the revenue of an adjusted EEO.
- 10.64 We also determine that Ofcom has not erred in the exercise of its discretion through insufficient investigation (and as a result, failing to provide a robust justification for its chosen approach) of whether an adjustment was appropriate.

⁷⁰⁷ TalkTalk NoA, paragraph 119; TalkTalk core submission, volume 1, paragraph 69.

⁷⁰⁸ Ofcom defence (TalkTalk Appeal), paragraph 113.

11. Determination

BT Appeal

11.1 Our determination on the reference questions which have been referred to us by the CAT in the BT Appeal is as follows:

- (a) In relation to reference question 3(b), Ofcom erred by applying the requirement set out at reference question 3(a) on a month-by-month basis.
- (b) Ofcom did not err in any other respects with regards to reference questions 1 to 5.
- (c) As to reference question 6, our view is that the appropriate remedy to correct the error we have found is for Ofcom to extend the compliance period to six months, applied on a fixed-date basis. The remedy we have identified can be given effect by way of amendment by Ofcom to the Legal Instrument and the Guidance. We therefore invite the CAT to direct Ofcom to amend the Legal Instrument and Guidance in line with the revisions we have proposed at Appendix C and Appendix D.

TalkTalk Appeal

11.2 Our determination on the reference questions that have been referred to us by the CAT in the TalkTalk Appeal is that Ofcom did not err in respect of either reference question 1 or 2. Accordingly, we were not required to go on to consider reference question 3.