SKY'S RESPONSE TO

OFCOM'S STRATEGIC REVIEW OF DIGITAL COMMUNICATIONS – DISCUSSION DOCUMENT

Executive Summary

1. Sky welcomes Ofcom's strategic review. It provides an opportunity to address a series of important issues that have implications not only for consumers of communications services in the UK, but also for the long term health of the UK economy.

2. It is critical that Ofcom approaches the review with vision, imagination and an open mind. The purpose of this *strategic* review should not be to confirm the merits of the *status quo*, or to search for potential minor adjustments in course. Ofcom should be prepared to consider options that have the potential to deliver significantly better outcomes in the communications sector over the next decade and beyond.

3. The review is an excellent opportunity to take a step back from 'business as usual', to consider what is working well in the sector, and what isn't. It also provides an opportunity to consider critical questions in relation to the UK's communications infrastructure – questions that risk falling between the gaps in Ofcom's regular cycle of market reviews.

4. It is now apparent that there is substantial concern with a series of growing problems in the sector, shared by a wide range of communications providers ("CPs), consumers, and politicians. These include:

    (i) the increasing dominance of high speed broadband services by BT, which risks unwinding the benefits of years of strong competition in broadband services;

    (ii) the inadequate quality of service delivered by Openreach – and its significant impact, every day, on large numbers of UK consumers and businesses, and

    (iii) the level and type of investment in the UK's fixed line communications infrastructure. In particular, it is evident that, at a time when fibre-to-the-premise ("FTTP") networks are being rolled out around the world – in places like Sweden, Lithuania, New Zealand, Spain and Portugal – BT's focus is on incremental upgrades to the old copper network. There are real questions to be addressed about whether the UK risks being left behind in terms of 21^{st} century connectivity compared to other countries around the world.

5. BT's vertical integration – the combination of the UK's largest retailer of fixed line communications services, with the operator of the UK's only ubiquitous fixed line access network – lies at the heart of these issues.

6. The fundamental question for Ofcom's review is whether the problems that have been identified merit a reference to the Competition and Markets Authority ("CMA") for a market investigation. The key purpose of the market investigation regime is to address situations in which markets as a whole are not working well, particularly due to structural features. The threshold for making such references is not onerous. In Sky's view, it is clearly met in this case, and Ofcom should consult on making a market investigation reference ("MIR") as soon as possible. It needs to act quickly because the problems

currently besetting the industry are causing harm now and are likely only to get worse. Without prompt action some of the adverse effects may be impossible to unwind.

7. Above all, Ofcom should consult on making a MIR because, if the CMA decides that there are significant problems in the sector, it has the power (which Ofcom does not) to implement structural remedies to those problems – as it has done in a number of other sectors that it has investigated – in airports, cement, and hospitals.

8. What Ofcom's review should *not* become is a debate about whether or not BT should be structurally separated. While Sky is firmly of the view that there would be significant benefits from such a separation, with little attendant cost or risk, that debate should properly occur as part of a market investigation undertaken by the CMA. It would be unfortunate for Ofcom to conclude after a lengthy consideration of this issue that there is a case for separation – and only then to make a MIR.

9. Nevertheless, Sky appreciates that Ofcom will wish to consider, at least at a high level, the issues associated with a potential structural separation of BT. This could deliver a range of important benefits, including:

- Deregulation; with separation, there would be little or no need for the plethora of regulation that seeks to deal with BT's vertical integration, such as much of the Undertakings and the complex VULA margin test. Regulatory resources could be deployed to focus on other issues;

- Boost to investment, including in last mile fibre-to-the-home networks by alternative operators. One of the often overlooked consequences of BT's vertical integration is that the largest retail provider of fixed line telecoms services in the UK, BT Retail, is tied to purchasing inputs from Openreach; its business is non-contestable. The ability to compete for BT Retail's business could incentivise alternative operators to invest in new infrastructure. This would also fundamentally alter the incentives facing a separated Openreach to make such investments – particularly in the 50% of the UK where it faces no competition from Virgin Media; and

- Increased competition. The threat of losing BT Retail customers is likely to have a transformative effect on Openreach, making it far more responsive to the needs of all its customers, including, for example, in relation to new product development, opportunities for co-investment, and service quality. No amount of behavioural regulation can provide such a stimulus.

10. In Sky's view, it is easy to envisage a world in which, with the benefit of hindsight, the question would become one of why we tried to 'paper over' the core structural issue in the UK communications sector via inadequate 'behavioural regulation' for so long.

11. Plainly, BT strongly opposes separation, and has put forward a number of assertions about why it would either result in poor outcomes, or be excessively costly to undertake. These are without merit. For example, assertions that being part of BT Group provides Openreach with access to investment capital are risible. An independent Openreach would be a major-FTSE listed company, with ready access to investment capital via the markets. And in relation to the costs and complexity of separation, such claims are overblown. Companies de-merge all the time – indeed as recently as 2002 BT spun off its mobile telecoms business (BT Cellnet) – and the recent vertical separation of Telecom New Zealand shows how relatively straightforward such demergers can be. In any event, many of the steps required for full structural separation - separated accounts, assets, employees, systems and processes - have been taken by Openreach which is already functionally separate.

12. Sky reiterates, however, that it is not necessary for Ofcom to reach a definitive view on the merits or otherwise of structural separation of BT in order to make a MIR to the CMA.

13. Even if Ofcom makes a MIR to the CMA any such inquiry would take up to two years, with a risk of subsequent legal action. Therefore there is a clear and urgent need for a strengthening via regulation of the independence of Openreach from BT, in the interests of all its major customers. For example: Openreach should have its own independent board and be free to set its own commercial strategy, customers should get a greater say in planned investment by Openreach, and Openreach assets should not carry BT branding. While such changes would not be a long term structural solution to the problems associated with BT's vertical integration, they would represent important interim steps in the right direction, and could pave the way for more structural changes.

14. Similarly, regardless of what happens in relation to these major questions raised by the review, there will be a continuing need for effective regulation by Ofcom in a range of areas, particularly where BT retains significant market power. Sky considers that, generally, Ofcom's overall approach is the right one. However, there is merit in Ofcom (a) giving greater attention to the promotion of alternative infrastructure investment, (b) ensuring that charge controls do not allow BT easily to earn excess profits, (c) playing a more proactive role in ensuring that Openreach improves its quality of service, and (d) not devoting unnecessary resources to 'consumer' issues when they could be used more productively elsewhere to empower consumers.

SKY'S RESPONSE TO

OFCOM'S STRATEGIC REVIEW OF DIGITAL COMMUNICATIONS – DISCUSSION DOCUMENT

Introduction

1. A thriving UK communications sector is crucial for the development of the economy. In this digital age, communications services have rapidly and inextricably become woven into the fabric of the everyday lives of nearly all businesses and individuals. As commerce and society moves online, the central role that the communications sector plays in driving growth and productivity has become even more pronounced.[1]

2. The successful development of the sector over the last 10 years has been in part attributable to a regulatory regime that created conditions that were conducive for efficient investment and innovation and which led to effective and sustainable competition over large parts of the value chain.

3. However, the sector is at a critical juncture. Decisions that are made now – including those made by Ofcom as part of its Strategic Review of Digital Communications ("SRDC") – are likely to have a profound, long-lasting effect on the industry and the wider economy. Degrading competitive conditions, poor service quality and concerns over the scale and the focus of investment are leading to poor outcomes for consumers, businesses and the economy.

4. Over the last decade, Sky has been at the forefront of the developments that have been so instrumental in transforming the sector. It has invested over £1bn in communications while delivering innovative, well-priced products and services such as faster broadband based on ADSL2+ technology and unlimited broadband which have proven to be popular with consumers. From a standing start in 2006, Sky is now the second largest broadband provider in the UK with well over 5m customers. Sky also makes available to most of its 12m customers a wide variety of compelling content to view over their broadband connections – irrespective of their broadband provider. Sky's commitment to the communications sector has been a key driver of broadband adoption in the UK.

5. Sky stands ready to invest more in the future or to collaborate with other major investors in order to continue to deliver good outcomes for consumers. It is crucial that market conditions remain conducive to this form of competition and investment as it is fundamentally important to the overall success of the sector in continuing to drive benefits for consumers, businesses and the wider economy.

6. Sky welcomes the opportunity to respond to this important review.

7. This response is in four parts:

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1 All paragraph references are to the discussion document, unless otherwise stated.

- **Part A** addresses the competition issues affecting the sector today which arise from BT's vertical integration and which justify Ofcom making a prompt MIR to the CMA.
- **Part B** explains that although Ofcom does not need to consider fully the case for structurally separating Openreach from the rest of BT in order to make a MIR, it would nevertheless be an effective remedy to the competition issues affecting the sector.
- **Part C** outlines the urgent need for significant improvements to be made to the current model of functional separation now as an interim measure to reduce the harmful effects of the competition issues.
- **Part D** discusses, irrespective of any steps taken to address issues arising from BT's vertical integration, the key roles played in fostering competition, investment and consumer welfare in the sector by (i) targeted regulation of Openreach's significant market power ("SMP"), and (ii) Ofcom's approach to consumer regulation.

PART A – COMPETITION ISSUES NECESSITATING A MARKET INVESTIGATION REFERENCE

8. As stated in Sky's initial submission to the SRDC ("Initial Submission"), the key focus of Ofcom's review should be on whether to make a MIR to the CMA under the Enterprise Act 2002 ("EA02") in relation to fixed line communications services. In this Part A Sky explains that the serious and growing problems affecting the communications sector demonstrate that making a MIR to the CMA should be central to the SRDC. The test for referral is clearly met and any delay in making a reference could be damaging to consumers, businesses and UK productivity. Ofcom already has sufficient evidence to make a MIR and it would be wrong for it to prejudge the outcome of that referral by undertaking a prolonged and unnecessary assessment of the effectiveness and proportionality of certain remedies – such as structural separation, which in any event it has no power to impose. It is essential therefore that Ofcom consults on a MIR in its proposed 'next steps / emerging views' document due to be published at the beginning of 2016.

The test for reference and the intensity of review required in phase I

9. The legal standard for a MIR is not a high one. Ofcom may make a MIR to the CMA where it has:

> "*<u>reasonable grounds for suspecting</u> that any <u>feature, or combination of features</u>, of a market in the United Kingdom for goods or services <u>prevents, restricts or distorts competition</u> in connection with the supply or acquisition of any goods or services in the United Kingdom…*"[2] (emphasis added).

10. The '*reasonable grounds*' standard requires sufficient analysis only to conclude whether there are reasonable grounds to suspect. It does not require a full or conclusive analysis of whether the features are in fact distorting competition, to what degree, or what measures to address the distortions would be appropriate and proportionate. It is for the CMA to carry out the market investigation and determine whether and to what extent the features identified distort competition, and what remedial action is required to remedy the adverse effects on competition if such distortions are found.

[2] Section 131 EA02.

11. The CMA's guidance on MIRs[3] (which was followed by Ofcom when it made a MIR in 2010) sets out the administrative criteria governing the circumstances in which Ofcom should make a reference. These are in summary that:

- sectoral or competition law powers at Ofcom's disposal will not be sufficient to address the concerns identified;
- undertakings in lieu of a MIR are not appropriate;
- the scale of the problems identified clearly merit a MIR; and
- there is a reasonable chance that appropriate remedies will be available.

12. For the reasons set out below, it is evident that the statutory test for a MIR is met and that the circumstances meriting a reference as set out in the guidance criteria are also present.

The statutory test for a MIR is clearly met

13. Initially, Ofcom's 2005 Telecoms Strategic Review ("TSR") delivered significant benefits as result of a combination of (i) the Undertakings[4] which created a functionally separate Openreach responsible for providing equivalent wholesale access to BT's fixed access and backhaul network to all CPs[5] and (ii) *ex ante* SMP regulation which set the terms of access (including prices) to Openreach's products and industrialised the processes involved.

14. However, as Ofcom has identified, although regulation has worked up to a point, the current regime is under increasing strain and faces a number of challenges resulting from:

- the ownership structure of BT and BT's profound incentives to favour its downstream operations;
- the blurring of the boundary that separates Openreach and the rest of BT in part due to the roll-out of fibre access networks; and
- poor service quality from Openreach.[6]

15. A further critical challenge facing the sector is BT's ability to win a high share of upgrades to superfast broadband which is leading to it establishing a dominant position in the retail broadband market.

16. Essentially, these problems arise from a combination of two market features: (i) BT's enduring upstream market power, associated with its ownership of the UK's only ubiquitous national fixed line infrastructure; coupled with (ii) BT's vertical integration. These two market features prevent, restrict or distort competition in the provision of fixed line communications services.

17. Functional separation of Openreach and its obligation to provide equivalent services does nothing to address BT's underlying incentive to favour its downstream operations. Ofcom

[3] 'Market Investigation References – Guidance about the making of references under Part 4 of the Enterprise Act', OFT 511 - https://www.gov.uk/government/publications/market-investigation-references.

[4] BT Undertakings given to Ofcom at the conclusion of the TSR dated 22 September 2005 (as amended) - http://stakeholders.ofcom.org.uk/telecoms/policy/bt-undertakings/.

[5] Openreach was also required to provide these products and services on an Equivalence of Inputs ("EoI") basis which requires it to offer all CPs access to the same products, processes and prices as it supplies to other BT downstream divisions.

[6] Paragraph 1.35.

has recognised that its "*current approach limits the ability to discriminate but does not address the underlying incentive, so risks to competition remain*" (emphasis added).[7] These risks to competition have materialised in numerous ways:

- diminishing retail competition in superfast broadband;
- competitive distortions stemming from the underlying economics of BT's vertical integration;
- BT's ability to raise the costs of its rivals through inappropriate cost allocations;
- Openreach's unresponsiveness to its external customers;
- BT's investment priority and management focus; and
- poor Openreach service quality.

18. Without repeating fully Sky's Initial Submission, we summarise these key competition problems below.

Diminishing retail competition in superfast broadband

19. With the transition to superfast broadband ("SFBB") gathering pace, the current regulatory regime governing access to BT's fibre based broadband network, combined with BT's vertical integration, is enabling BT to establish a dominant position at the retail level.

20. BT Retail already accounts for at least 74%[8] of all SFBB lines on the Openreach network compared to 40% for all (standard and superfast) broadband connections on the network;[9]

[redacted]

[redacted]

21. Going forwards, BT is forecasting a large share of new retail SFBB subscribers.[10]

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7 Paragraph 11.5.

8 See paragraph 3.55, 'Statement on the Approach to the VULA margin', 19 March 2015, (http://stakeholders.ofcom.org.uk/binaries/consultations/VULA-margin/statement/VULA_margin_final_statement.pdf).

9 See table 16, 'summary of residential and small business broadband connections in Q4 2014, Telecommunications market data tables, Q4 2014', http://stakeholders.ofcom.org.uk/binaries/research/cmr/telecoms/Q4_2014_telecoms_tables.pdf.

10 See paragraph 3.55, 'Statement on the Approach to the VULA margin' *op. cit.*

Competitive distortions stemming from the underlying economics of BT's vertical integration

22. BT's vertical integration means that payments between downstream and upstream BT divisions are 'wooden dollars' (*i.e.*, notional internal transfer charges). On the other hand, the Openreach charges that external CPs face (such as the costs to upgrade to SFBB) represent a real economic cost which directly impacts the profitability of CPs. Therefore, high Openreach prices can have a greater impact on BT's retail competitors and distort competition.

[redacted]

[redacted]

23. [redacted] illustrates this point. For BT Retail, upgrading a standard broadband (DSL) customer to fibre is loss-making on paper but overall at the BT Group level it is profitable and therefore BT has an incentive to migrate its retail DSL base onto SFBB. For Sky however the upgrade cost is a real economic cost and not merely an internal transfer charge as it is for BT Retail.

BT's ability to raise the costs of its rivals through inappropriate cost allocation

24. By exploiting the scope afforded by the current regulatory regime to allocate costs between different products, BT has been able to raise the wholesale price of key inputs and often of inputs used only by its downstream rivals (or in relatively larger proportions).[12] As noted above, even to the extent that BT's downstream divisions faced these higher prices, they would be 'wooden dollars' and therefore would have less effect on those divisions compared to other retailers.

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11 [redacted]

12 In its document entitled 'Review of BT's cost attribution methodologies' of 12 June 2015, Ofcom has provisionally concluded that BT's approach to allocating costs was inappropriate (amounting to £262m wrongly allocated to regulated products). http://stakeholders.ofcom.org.uk/consultations/cost-attribution-review/.

Openreach's unresponsiveness to its external customers

25. Sky spends approximately [redacted] with Openreach but has often been disappointed by its lack of responsiveness to its proposals and to product development requests more generally. As shown in Table 1, overall a higher proportion of new product and service requests (known as Statements of Requirements, "SoRs") made by internal BT divisions are developed and more quickly than those generated by other CPs. BT's vertical integration is likely to be a factor in this differential.

Table 1: Proportion of submitted SoRs implemented by Openreach[13]

SoRs submitted by:	Number of SoRs submitted	SoRs delivered / in development	% of SoRs delivered / in development that were delivered within 1 year	% of SoRs delivered / in development that were delivered within 2 years
BT Group	169	87 (51%)	40%	75%
Non-BT Group	145	35 (24%)	34%	69%

BT's investment priority and management focus

26. Although Openreach is functionally separate from the rest of BT, it remains vertically integrated and its operating plan (including its budget for capital and operating expenditure) is nevertheless approved by BT Group (Openreach's CEO also reports to the BT Group CEO) and this influences investment decisions.

27. For example, BT Group did not provide Openreach with any additional funds with which to invest in the roll-out of its SFBB network. Instead Openreach's relatively modest investment in fibre-to-the-cabinet ("FTTC") has been largely achieved without any substantial increases in its total capex budget (which is controlled by BT Group).[14]

28. Moreover BT has indicated that all of Openreach's future fibre investments – such as in G.fast – are likely to be managed broadly within current capex levels.[15]

29. Openreach's investment capability is often influenced by factors exogenous to Openreach such as the financial performance of other BT divisions within the vertically integrated group like BT Global Services. As a consequence, in order to roll-out FTTC Openreach has reduced capex investment elsewhere – mainly in the capital maintenance of its underlying copper and duct network.

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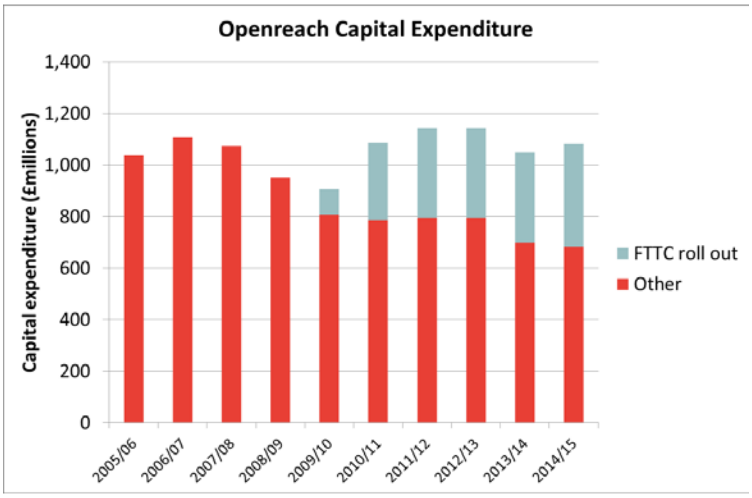
13 Source: Openreach Statement of Requirement tracker. Includes all shared SoRs and Sky SoRs marked as non-shared. Sky understands that other non-shared SoRs represent a very small minority.

14 Along with the budgets of the other BT lines of business, Openreach's capex has been kept at relatively supressed levels ever since BT announced a £2bn charge for BT Global Services in 2008/9.

15 For example, see Tony Chanmugam's comments on page 10, 'Q3 2014/15 Results Conference Call Transcript', 30 January 2015 - https://www.btplc.com/Sharesandperformance/downloads/PDFdownloads/q315-transcript.pdf.

Figure 3: Openreach capital expenditure[16]



30. This under-investment in the underlying network (which is relied upon by both standard and superfast broadband services) has adversely impacted network reliability resulting in increased fault rates and longer provisioning times (see paragraph 34 below).

31. During this period of flat overall investment and deteriorating service quality, Openreach while accounting for less than 30% of BT Group's total revenue has been a key contributor of profits and cash for the group[17], generating:

- circa £2.5bn per annum in EBITDA with margins over 50% (representing over 40% of BT Group's total EBITDA); and
- circa £1.5bn per annum in free cash flow (over 50% of BT Group's total cash flow).

32. These high profits have come about despite the vast majority of Openreach's services being subject to regulated charge controls. Estimates of the profits earnt in excess of Openreach's cost of capital between 2006 – 2015 range from £4bn (Ofcom) to £5.5bn (Frontier Economics).[18]

33. It is evident that Openreach 'punches above its weight' in contributing to the financial well-being of BT Group but that there appears to be little prospect (under the current company structure at least) of it being provided with substantial additional funds for really significant investments such as those that would be required to deploy FTTP.

<u>Poor Openreach service quality</u>

34. As explained above, deteriorating Openreach service quality has in part been caused by under-investment in the underlying copper network which along with the rest of Openreach's operating plan would have been approved by BT Group. Ofcom acknowledges that the delivery and reliability of Openreach's products and services are a specific area of concern and that there is a consensus that Openreach is not delivering a good quality of

16 Source: BT KPIs and Frontier Economics estimates.

17 Source: 'BT KPIs, 6 year income statement, Q1 2015/16' - https://www.btplc.com/Sharesandperformance/Quarterlyresults/index.htm.

18 Paragraph 4.52.

service.[19] Sky set out in its Initial Submission detailed evidence on the scale and scope of Openreach service quality problems including:

- approximately 90% of new line installations, which require an Openreach engineer to attend, take 10 calendar days or longer while almost one in ten installations takes longer than 30 days;

- Openreach changes the agreed installation date for Sky customers on average around 12,500 times a month. Given Sky customers represent approximately one third of all those on the Openreach network, this would imply that c.37,500 households are affected each month in the UK;[20]

- Openreach misses over 500 appointments each month to install new lines for Sky customers and fails to complete a further 4,000 jobs per month (which could equate to approximately 1,500 appointments and 12,000 jobs across the UK);

- fault rates across Openreach's network increased by 50% between 2009 and 2012, the last year for which reliable data is publicly available; and

- Openreach's performance in fixing faults is consistently below the targets set out in agreements with service providers.

35. While the direct impact on business and consumers of (i) being without essential communications services, (ii) delays in accessing new services, or (iii) missed and changed appointment dates is serious enough, it is also important to appreciate that poor Openreach quality of service dampens consumer switching and in turn competition. Moreover, even if service quality is uniformly poor for all CPs, BT Retail is likely to benefit as it has the largest base of customers so has more to gain from dampened switching.

36. It is clear from the significant problems in the UK communications sector summarised above that the statutory "*reasonable grounds to suspect*" reference test is met.

The administrative criteria for a MIR are also satisfied

37. The administrative criteria governing the circumstances in which Ofcom should make a reference are also satisfied as:

- Sectoral or competition law powers at Ofcom's disposal are not sufficient to address the concerns identified. Standard competition law powers would be unable to remedy the problems discussed above; they could not reasonably be considered to be breaches of Chapters 1 or 2 of the Competition Act 1998. In relation to Ofcom's sectoral powers, it is notable that the problems set out above have emerged despite the application of those powers. Ever more complex behavioural regulation cannot fundamentally address the issues which arise from BT's ownership of Openreach.

- There appears to be no prospect that BT would offer undertakings in lieu of a MIR that would be a sufficiently comprehensive solution to the structural problems identified. Although in principle, BT could undertake voluntarily to divest Openreach, which could remove the need to make a reference, this seems highly unlikely given BT's publicly-stated position to date.

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19 Paragraph 1.67.

20 This is a broad assumption based on Sky's market share which aims to give an illustrative figure, and does not take into account any differences between CPs using the Openreach network in the levels of gross additions, or mix of products taken, that may affect the gross figure for the UK.

- The scale of the problems identified above clearly merit a MIR. The size and proportion of the markets affected are significant and the features (BT's upstream market power and its vertical integration with Openreach) giving rise to the problems discussed above are persistent. As explained above, the erosion of competition in broadband services has potentially far-reaching consequences for consumers and businesses, and for the UK's economic prospects more generally, while the ongoing problems in relation to Openreach's quality of service are persistent, substantial and affect large numbers of consumers and businesses every year.

- The CMA has a broad relevant experience and it alone has the full toolkit to remedy any identified problems. It is the only regulator that has the power to deliver on all the possible courses of action, in particular structural separation of Openreach from the rest of BT, that Ofcom states may address the identified problems in delivering effective competition in fixed communications. Ofcom does not have the necessary legal power to order structural separation

38. Accordingly, the statutory test for reference is met and the circumstances in which Ofcom should make a reference as set out in the administrative criteria are also present.

Ofcom does not need to consider the appropriateness or proportionality of any potential remedies before it makes a MIR

39. Ofcom has set out in its discussion document the possible courses of action that may address the issues that it has identified arising from BT's vertical integration including strengthening the current model of functional separation and considering structural separation. Ofcom then sets out some of the merits and challenges of these options.[21]

40. However, it is inappropriate for Ofcom to assess the proportionality or merits of structural separation or other remedies that may result from a potential MIR at this stage. To seek to determine these issues at this point would be to 'put the cart before the horse' and goes against the legislative intention behind the MIR regime.

41. It would be wrong for Ofcom in the first phase to undertake the type of in-depth market analysis and assessment of potential remedies that is envisaged for the second phase to be conducted by the CMA. Separation of the two phases with the involvement of a non-sectoral regulatory body is a key foundation of good decision making and should not be circumvented by Ofcom.

42. Ofcom does not need to conclude therefore on the existence or extent of any competition problems and the proportionality or appropriateness of any potential remedies as part of the SRDC; this is a matter for the CMA, not for Ofcom.

The urgent need for a reference

43. Ofcom must act swiftly as the sector is in an important transitional period making the competition problems which are causing harm now (and are likely to only get worse) difficult to unwind. For example, the rate at which BT is adding SFBB subscribers to its existing large broadband base means that there is a strong possibility that it will establish a dominant position in the retail broadband market. Given this urgency, Ofcom should avoid engaging in a detailed lengthy investigation and instead make a prompt MIR to the CMA.

44. This is a dynamic and fast-moving sector which necessitates that Ofcom acts with expediency to try to resolve any identified problems. Even if Ofcom were to make a MIR in the first half of 2016, it would extend any potential remedial action out to late 2017 / early 2018 (even before any implementation steps).

21 Figures 31 and 32.

45. In other sectors, regulators have recognised the need to act promptly and have made relatively quick MIRs without the need to complete detailed lengthy investigations (in keeping with the standard and intensity of review required in the first phase). For example, the CMA recently made a MIR in relation to retail banking following a short preliminary market study.[22] The current state of play in the communications sector warrants a similar swift MIR by Ofcom.

46. Ofcom has already taken the necessary preliminary steps to consider whether a MIR is required. With the announcement of the SRDC in March this year, and the publication of the discussion document in July, Ofcom has started the necessary preliminary market analysis to support a MIR to the CMA and the logical next step is for Ofcom to consult on a MIR at the beginning of next year.

Conclusion on making a MIR

47. Making a MIR would not reflect adversely on Ofcom's expertise or competence to address any concerns resulting from the SRDC. Instead, a MIR would allow the CMA to conduct an in-depth 'fresh' analysis of the communications sector and design effective remedies to address any identified adverse effects on competition building on its significant and valuable cross-sector experience.

48. In Section 9 of the consultation, Ofcom discusses "*possible concerns from bundling content and telecoms services*". We discuss these possible concerns, which are unfounded, in Annex 1. For the present purposes, however, even if they were valid, none of the content-related issues discussed in Section 9 of the consultation would undermine the case for Ofcom making a MIR in relation to UK communications services.[23]

49. In summary, there is compelling evidence that there are significant and worsening problems in the UK fixed communications sector - largely as a result of BT's vertical integration and its upstream SMP. Therefore, it is essential that Ofcom acts quickly and consults on a MIR at the next stage of its strategic review.

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22 'Competition and Markets Authority case: Retail banking market investigation', opened 19 June 2013 - https://www.gov.uk/cma-cases/review-of-banking-for-small-and-medium-sized-businesses-smes-in-the-uk.

23 More generally, it would be unfortunate if proper consideration of the important strategic issues in relation to competition and investment in the UK's communications sector raised by Ofcom's review were diverted by an unnecessary detour into such issues.

PART B - STRUCTURAL SEPARATION WOULD DELIVER SIGNIFICANT BENEFITS WITH LIMITED DOWNSIDE RISK OR COST

50. As discussed in Part A, it would be inappropriate for Ofcom to predicate any decision for a MIR on an assessment of the merits and challenges of structural separation of BT. Nevertheless, Sky appreciates that Ofcom will wish to consider, at least at a high level, the issues associated with a potential structural separation of BT. Accordingly, in this Part B we explain how structural separation (alongside streamlined, targeted regulation - which we discuss in Part D) would be likely to deliver significant benefits, with limited downside risks.

51. It is Sky's position that the structural separation of Openreach from the rest of BT (creating a FTSE100 company that should be highly appealing to investors) coupled with appropriately designed, focused regulation could provide a permanent foundation for galvanised, better functioning communications markets and, therefore, would be superior to the 'cat and mouse' regulation which has failed to prevent serious harm to competition and consumers (and is likely to continue to do so in the future).

52. Structural separation would liberate all market players (particularly Openreach and BT's downstream divisions) and would unlock a series of positive, pro-competitive outcomes including:

- increased competition;
- increased investment;
- Openreach being able to focus solely on its core business; and
- substantial deregulation.

We explain these benefits in more detail below.

Increased competition

53. Structural separation increases competitive intensity because BT Retail's business, with its large subscriber base, becomes truly contestable. BT's downstream divisions such as BT Retail would be free to contemplate purchasing upstream services from suppliers other than Openreach. For the first time, upstream suppliers could compete for some of BT Retail's business. For instance, in some areas BT Retail could consider buying wholesale FTTP services from alternative infrastructure providers – for example, established operators like CityFibre or entrants such as Arqiva or Fujitsu.

54. The scale of BT Retail's subscriber base (representing c.32% of the broadband market and c.37%[24] of the landline market) is such that its custom could transform the viability of these competing upstream suppliers leading to benefits for all downstream CPs not just BT Retail. This is important because the high fixed costs associated with rolling out upstream networks – particularly FTTP networks – necessitate that the networks attract enough subscribers to be economically viable. As long as BT Retail remains integrated with Openreach there is little prospect of other upstream operators attracting its business meaning that the addressable market in a given area for these operators is often too low and far smaller than the total market.

55. Sky has direct experience of these issues including from its fibre trial with CityFibre and TalkTalk in York. [redacted]

[24] 'Facts and Figures', Ofcom - http://media.ofcom.org.uk/facts/.

[redacted] The prospect of an upstream operator being able to also attract some of BT Retail's business to a putative network could make the difference to whether it is rolled out and viable or not. There would be a clear benefit to all broadband providers if upstream operators were able to deploy effective and sustainable networks more widely and the contestability of BT Retail's business could make that possible in certain cases.

56. This new competitive dynamic would have a profound effect on Openreach who would be faced with the threat of losing some of the business of its largest downstream customer in addition to the risk of losing some of the business of its external customers – which could make the difference between the alternative network being built or not. This threat would instil a competitive response that no amount of behavioural regulation could ever successfully mimic by providing the necessary spur to Openreach to compete more effectively (within the bounds of what is fair and reasonable) for the business of all its customers including that of BT's downstream divisions.

57. Openreach would also have a stronger incentive to compete for the business of other major downstream retailers because their subscriber volumes would become increasingly crucial to Openreach as it could no longer depend on BT Retail's business. Openreach could for example respond to this risk by improving its service quality or investing in FTTP itself.[26]

Increased investment

58. Structural separation is also likely to increase overall investment levels. A simple consequence of the increased competition that stems from the contestability of BT Retail's business is that upstream operators including Openreach will invest more in their existing networks (or in new ones), products and services in order to make them more attractive to retailers generally.

59. Further, investments in new networks that previously were not made because upstream operators were unable to guarantee sufficient demand from downstream operators could go ahead if some of BT Retail's business were also available. Its scale will make some network deployments economic.

60. For Openreach, it would be free to coordinate with all of its customers, not just with BT Retail as it claims it does today[27], to help underwrite significant new network investments. These arrangements which could include co-investment models, anchor tenancy agreements or minimum guarantees would be significantly more effective in mitigating investment risk than the current model – particularly where it relates to demand risk. Notably, this model of greater coordination between Openreach and its downstream customers need not entail Openreach increasing its overall level of investment - although this too is likely. Downstream operators would be inclined to invest more themselves.

61. Assuming the financial structures of any co-investments are akin to 'network ownership economics' in that they entail high fixed capital costs with little ongoing variable costs for both parties, then the downstream operator is also incentivised to invest downstream in order to promote the products and services provided via the co-investment initiative.

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25 [redacted]

26 We consider the scope for effective upstream competition and the role regulation can play in supporting it more fully in Part D.

27 For example, see 'BT lashes out in battle over future of broadband network; Consumer chief John Petter blasts Sky and TalkTalk over attempt to split company', The Telegraph, 17 March 2015 – http://www.telegraph.co.uk/finance/newsbysector/mediatechnologyandtelecoms/telecoms/11478655/BT-lashes-out-in-battle-over-future-of-broadband-network.html.

Openreach would focus on its core business

62. Unlike the situation today where its strategic direction is either 'crowded out' by other BT Group objectives or manipulated to deliver wider benefits to the Group, Openreach would have full control over its business strategy. In having the sole aim of optimising its wholesale revenues and profits for its shareholders – without being constrained by the often competing group-wide incentives to maximise retail market share (where it is often more profitable than increasing overall wholesale demand) or maintain stable capex levels as a result of under-performance elsewhere in BT Group (*e.g.*, BT Global Services) – all its customers would benefit.

63. This simple, unencumbered aim is what the communications sector requires (coupled with appropriate regulation to prevent Openreach from leveraging its market power) as it provides the foundation for effective downstream competition.

Deregulation

64. A key benefit of structural separation is that large swathes of the complex behavioural regulation aimed at preventing BT from acting on its incentive to favour its downstream divisions would become redundant and could be removed. For example, much of the Undertakings would no longer be necessary. Reducing the regulatory burden in this way should be an appealing prospect for BT and Ofcom in particular.

65. The regulation that would remain would be simpler, more streamlined and focused mainly on addressing concerns arising from Openreach's upstream market power. There is a 'deregulatory dividend' that comes with this more narrowly focused regulation. With the removal of burdensome behavioural regulation, Ofcom and Openreach can turn their undivided attention to implementing new regulation aimed at significantly improving service quality to levels far more in keeping with the pivotal role communications services play in the lives of consumers, businesses and the wider economy.

Objections to structural separation are without merit

66. Discussion of the possibility that Openreach could be divested from BT has caused BT to put forward a series of assertions as to why such a divestment would either (a) result in worse outcomes than continued BT ownership, and / or (b) involve substantial transitional costs. Sky addressed these assertions in its Initial Submission to the SRDC and therefore we only briefly discuss these issues here.

67. BT's assertions in relation to transitional costs are overblown. Company demergers happen all the time, with relatively modest transition costs. Indeed, BT itself spun off its mobile business (BT Cellnet) in 2002. More recently, Telecom New Zealand separated voluntarily into network (Chorus) and retail (Spark) businesses, in a straightforward way.

68. It is probable that a demerger of Openreach from BT would be an order of magnitude more straightforward to achieve than the proposed integration of EE into BT – which BT is more than willing to undertake.

69. Above all, as we have observed previously, the fact that Openreach is already functionally separated from BT means that a great deal of the work normally required to complete a divestment – such as separation of IT systems, staff and assets – has already been undertaken. This serves to minimise the transition costs of a demerger.

70. None of the predicted adverse consequences that BT has so far put forward in this debate have merit.

71. For example, BT has asserted that being part of BT Group provides Openreach with investment capital to which it would otherwise not have access.[28] Such a proposition is risible. An independent Openreach would be a major-FTSE listed company, with ready access to investment capital via the markets. An assertion that Openreach would not be able to finance any investments that it needs to make is without merit.[29]

72. Similarly, we have previously addressed BT's assertion that without BT Retail acting as an 'anchor tenant' Openreach will be disincentivised from making significant new investments. As discussed in Sky's Initial Submission, the analogy of anchor tenancy is misplaced – it is a concept that applies when companies are *not* vertically integrated and significant upstream investments are required. In fact, BT's argument supports the opposite case: that there is a myriad of ways in which firms are able to support substantial new investments in situations without vertical integration, via contractual solutions.

73. In summary, to date, no credible arguments in relation to significant adverse consequences that would arise from divesting Openreach from BT have been put forward.

74. Sky urges Ofcom to examine carefully situations in which structural separation in other countries in the fixed line communications sector has been achieved and works effectively – in particular, to Sky's knowledge, in New Zealand, Sweden and Singapore.[30]

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28 See for example, 'Openreach boss: 'A huge mistake if Openreach were spun off as an independent company', Joe Garner, The Telegraph, 13 September 2015 - http://www.telegraph.co.uk/finance/newsbysector/mediatechnologyandtelecoms/digital-media/11862314/Openreach-boss-A-huge-mistake-if-Openreach-were-spun-off-as-an-independent-company.html.

29 BT has also asserted that a separated Openreach would not have access to BT's research capabilities. This appears to presume that none of those capabilities would transfer to Openreach in the event of a divestment – which is an unrealistic assumption.

30 Sky notes that BT has asserted that separation has been a disaster in Australia and New Zealand. In relation to New Zealand, this simply betrays a lack of knowledge of the facts. In relation to Australia, the assertion confuses two entirely separate issues: (i) Australia's National Broadband Network Co ("NBN Co") programme – a state owned entity set up to roll out a national FTTH broadband network – and (ii) the purchase by that entity of the access network assets of the incumbent telcos, Optus and Telstra. It is the former that has been highly problematic.

PART C - THE NEED FOR FUNDAMENTAL REVISIONS TO FUNCTIONAL SEPARATION IN THE INTERIM

75. Whatever the outcome of a MIR, there is also an urgent need in the interim for Ofcom to make fundamental improvements to the current model of functional separation to address - albeit partially - the serious issues affecting the sector.

76. Even with a prompt referral to the CMA, the subsequent market investigation could take at least 18 months before it is concluded and may also entail an extended period thereafter to implement any remedies and resolve any legal challenges from BT.[31] This is far too long to allow some of the severe problems affecting the industry to erode competition further and therefore it is appropriate in the interim for Ofcom to take steps now to strengthen the existing regulation of BT.

77. Although an imperfect solution compared to full structural separation and therefore only a temporary solution, strengthening the current functional separation model could go some way towards further reducing the market distortions that currently arise as a result of BT's vertical integration. Taking these steps now will also act as a bridgehead to full structural separation (should it be considered necessary) and therefore reduce even further any transitional costs of formal separation.

78. However, these interim measures must also be accompanied by measures to address significant problems with the current traditional *ex ante* regulatory regime. We discuss these in Part D of this response.

Improving functional separation in the interim

79. The Undertakings were largely focused on delivering LLU-based competition, which they did successfully. While their positive impact on competition has been significant, it is now clear that the Undertakings also suffer from weaknesses which are a key cause of the serious problems affecting the industry. These weaknesses fall into two broad categories:

- **Systemic** – where key clauses of the Undertakings permits working practices which enable BT to favour its own interest, for example:
    - through the control BT Group exerts over Openreach's commercial strategy; and
    - by exploiting 'parallel' equivalence where CPs competing with BT in the same downstream markets use different upstream Openreach inputs to BT (or in different proportions).
- **Temporal** – whereby the model of functional separation is no longer adequate to constrain BT as originally intended because of changes in technology and competition that were not easily identified when the Undertakings were initially designed. This is evidenced by:
    - a build-up of variations and exemptions to the Undertakings which, taken as a whole, have undermined their initial purpose;[32] and

[31] BT has threatened years of litigation should it be required to separate structurally Openreach from the rest of BT. See 'BT's Patterson: Why splitting the company is without merit', The Telegraph, 18 July 2015 - http://www.telegraph.co.uk/finance/newsbysector/epic/btdota/11748496/BTs-Patterson-Why-splitting-the-company-is-without-merit.html.

[32] See footnote 9 of Sky's Initial Submission.

- a blurring of the boundary between Openreach and the rest of BT so that it (i) provides more active products and (ii) increasingly operates at more than one point in the value chain.

- The main example of Openreach providing more active products is the variation to the Undertakings that allows it to offer an *active* wholesale SFBB product, Generic Ethernet Access ("GEA", the regulated term for this is Virtual Unbundled Line Access, "VULA"). Openreach is now able to install and control electronic equipment in the local access network, something that was expressly prohibited in the Undertakings initially because active products – particularly in the local access network - were unlikely to expose enough of the value chain to competition. This had been the problem with BT's wholesale bitstream broadband products before and which LLU, a passive product, had largely solved. Openreach does not provide an EoI passive input for GEA so it is not possible for CPs to use Openreach products in order to 'self-assemble' a similar service and compete more effectively.

- While Openreach does not provide a passive input for GEA specifically, it is increasingly offering both passive and active products *i.e.* operating at more than one point in the value chain. For example, it is currently obliged to offer passive products like Physical Infrastructure Access ("PIA") for local access and, potentially in the future, 'dark fibre' (for business connectivity / leased line services) while it also offers active services downstream such as GEA and Ethernet leased line services. One key weakness with the way in which Openreach is allowed to operate in both the active and passive layer is that it is not obliged to ensure that the active products it sells are based on EoI passive inputs. For example, GEA is not required to be made up of sub-loop unbundling ("SLU").

80. These issues are clearly problematic for effective competition. This is because CPs are often likely to be able to compete more effectively at scale on the basis of passive inputs (as has been the case with LLU based competition) whereas active products are likely to be more profitable to BT. This is the case both (i) on a narrow assessment where active products will naturally be more expensive and profitable than passive ones for Openreach and (ii) more broadly because it is often more profitable for BT Group for its retail divisions to have higher market shares and this is more likely when competition is based on active inputs. It is evident that the potential for BT to distort competition when it is operating in both the passive and active layers is substantial.

81. These weaknesses mean that the Undertakings no longer provide a full solution to the competition problems they were designed to address. It is possible however to make some improvements to the functional separation model.

82. A partial solution to the <u>systemic</u> failings would be to tighten the rules that currently allow BT Group to exert undue influence over Openreach. This could include:

- **Better customer engagement by Openreach on major infrastructure projects** – this could be achieved by introducing new rules aimed at (i) obliging Openreach to consult fully with all its customers on major network investments – such as those in fibre access – at a far earlier, formative stage than currently anticipated in the SoR process and (ii) where investment risks necessitate, ensuring that all CPs have a fair opportunity to help mitigate those risks through coordination with (or commitment to purchase from) Openreach (including through co-investment models which incentivise CPs to promote new services on the new infrastructure by exposing them to high fixed costs and relatively low variable costs).[33]

[33] Without full structural separation it may not be possible to design risk sharing rules that completely remove the scope for Openreach to discriminate in favour of BT's downstream divisions.

- **Open tendering for the business of downstream BT divisions** - in order to introduce more upstream competition and reduce the scope for unfair coordination with Openreach, downstream divisions such as BT Retail should be obliged to run open and fair tendering processes for their business. Other upstream suppliers, not just Openreach, could tender to supply wholesale inputs to BT's downstream divisions – perhaps on a regional basis.

- **A fully independent Openreach board** - made up of non-executive directors, the chief executive of Openreach and, potentially, another executive director of Openreach where no member can hold any position on any other BT board or committee. The Openreach chief executive would have a sole responsibility to serve the Openreach board and have no other reporting lines to other parts of BT Group.

- **Removing (or significantly narrowing) the exemption criteria in 'Annex 2' of the Undertakings** - whereby currently a long list BT Group functions are entitled to access Openreach commercial information (Annex 2, Parts A and B) and, crucially, to influence its commercial policy (Annex 2, Part A).[34]

- **Budget autonomy** – giving Openreach full control over its budget. Currently for example the Undertakings only allow Openreach to have autonomy over £75m per annum of capex compared to Openreach's total capex budget which typically exceeds £1bn per annum.

- **A fully independent Equality of Access Board ("EAB") and Equality of Access Office ("EAO")** – external to BT with full 'audit style' access rights to BT and stronger powers to enforce compliance with the newly strengthened Undertakings.

- **Removal of all BT branding** – maintaining the BT logo and branding on Openreach assets including fleet vehicles, engineer uniforms and street cabinets, poles and master sockets – is inappropriate and anachronistic given that Openreach is supposed to provide equivalent services to all retailers. Downstream competitors are not on an equal footing with BT Retail for as long as the highly visible Openreach presence – be it the engineers who attend customers' homes, the master sockets in every house and business, or the thousands of vans driving round our villages, towns and cities - bears the BT brand. Openreach should be working on behalf of all of retailers not just BT Retail.

- **Stronger enforcement of the Undertakings** – in order to incentivise compliance it would be justified if Ofcom were to act quickly and firmly should BT breach the Undertakings.

83. In order to address the <u>temporal</u> issues, Ofcom could reaffirm the key principles that apply to Openreach, clarify the boundary around Openreach and introduce new rules to ensure that it is not able to distort the development of competition between active and passive layers. Possible changes to the Undertakings to achieve this end could include:

- a clear aspiration for Openreach to sell EoI passive products – it is on this basis that competition is likely to be most effective because it exposes more of the value chain to competition leading to greater levels of investment and innovation which in turn can provide consumers with greater choice and lower prices;

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[34] The group functions include any BT Group board member, legal & regulatory, strategy, technology, commercial policy and finance. The key purpose of many of these group functions will be to optimise outcomes for BT Group (*e.g.*, to maximise shareholder returns) which may entail promoting its downstream businesses. The Undertakings place few limits on the extent to which these exempted positions are entitled to influence Openreach commercial policy.

- the selling of active products should be by exception only but where this does occur Openreach must identify and make available an EoI input(s) upon which the active product is based and be required to not discriminate unduly between the passive upstream input(s) and the active product; and

- should competition based upon passive inputs become sufficiently established then it may be appropriate for Openreach to no longer sell the relevant downstream active product.

84. In practical terms, these proposals could result in Openreach developing EoI upstream inputs for GEA such as SLU, dark fibre and / or PIA. Operators wishing to invest further up the value chain could use these upstream inputs in order to self-assemble their own active SFBB services. Another example would be a requirement for all Openreach Ethernet leased line services to be based on an EoI dark fibre product.[35]

85. These changes to regulation are not by themselves sufficient to create the conditions which are conducive to the development of competition as high up the value chain as is effective and sustainable. There also needs to be appropriately designed and focused *ex ante* SMP regulation alongside. Evidently, the prices of active and passive services will have a profound bearing on the scope for competition to develop at different points in the network. We consider these issues in Part C where we discuss the role SMP regulation including price controls (for example, on GEA) will have in fostering competition and investment.

86. In summary, for a variety of reasons the Undertakings have become outmoded. Quickly improving the model of functional separation (alongside appropriately targeted 'traditional' SMP regulation) is an essential interim step given the current pressing issues affecting the sector and the time it would take to implement a more comprehensive solution such as structural separation.

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[35] In the current Business Connectivity Market Review, Ofcom is proposing to oblige BT to offer dark fibre but is not proposing that Openreach's Ethernet leased line products should be based on an EoI version of it. This opens up further scope for market distortions to develop.

PART D – ONGOING REGULATION

87. Irrespective of the outcome of a MIR and any improvements to the model of functional separation to create the right environment for effective competition to develop in the sector, it is crucial that these mainly 'vertical' remedies are complemented by appropriately designed 'traditional' SMP regulation of Openreach. Accordingly, in this Part D we discuss the role of continuing SMP regulation.

88. Structural separation may enable the removal of layers of complicated behavioural regulation and is likely to expose BT to more competitive constraints but BT, through Openreach, would still own and control the UK's only ubiquitous fixed access network. Regulation aimed at preventing it from inappropriately exercising its SMP will therefore be required to work in tandem with any vertical solutions.

89. There are a series of issues which traditional SMP regulation should aim to address and which may necessitate a change in emphasis by Ofcom. These include:

- ways to support effective competition and investment;
- ensuring that Openreach's returns on regulated products are not unduly excessive; and
- the requirement for significant improvements in Openreach service quality.

90. While each relatively discrete issue is individually significant in delivering effective competition, investment and consumer welfare, collectively they represent an essential package of measures *i.e.* the minimum that is required to make continuing SMP regulation effective and fit for the future.

91. We discuss these issues in the remainder of Part D. Before addressing the issue of ways of supporting effective competition and investment, however, we must first consider whether the current market structure will deliver the levels of network investment required in the UK. This is an important question which SMP regulation alone may not be able to solve. However, it is a crucial consideration when assessing the scope for effective and sustainable competition and investment in the sector and the role regulation pays in delivering it.

The fundamental network investment questions

92. While Ofcom's discussion document considers various models of promoting competition and investment (which we discuss below in this section), it fails to address some of the key questions facing the UK communications sector, namely: (i) what types of fixed line infrastructure does the UK need to remain competitive over the next 25 years? and (ii) will the current or future market structures deliver that infrastructure?

93. These are critical issues that need to be considered in Ofcom's SRDC. Along with education and innovation capabilities, investment in the UK's infrastructure has been identified as one of the three key areas in which the UK must 'raise its game' if it is to improve the prospects for productivity growth, and therefore increased standards of living over time. While infrastructure investment needs in areas such as airports, transport (particularly rail) and energy receives considerable public and government attention, it is plain that the issue of investment in the UK's fixed line communications infrastructure merits considerably greater attention.

94. This is because, as noted in Sky's Initial Submission, communications infrastructure is particularly important due to its role as a 'general purpose technology' – a technology that underpins the performance of a broad range of sectors. It is evident that in the knowledge-based digital economy of the 21st century, reliable high capacity broadband connections are integral to a nation's future economic prospects. It is also evident that

investment in such infrastructure has the possibility of driving substantial social returns, over and above the private returns to investment.

95. When viewed in this context it seems almost inconceivable that decisions over the form, extent and timing of investment in this critical national infrastructure are taken by one firm, which is integrated vertically with a substantial retail business, and which has strong incentives to sweat its existing, sunk cost copper network.

96. One of the fundamental questions that Ofcom's review should consider is whether it is sufficient to rely on incremental upgrades to the UK's last mile copper network over time – the course that BT prefers – or whether the public interest would be better served by a widespread roll-out of FTTP.

97. There are numerous reasons in favour of such investments. For example:

- future proofing – FTTP networks would be able to accommodate exponentially growing demand for data transfer (both in terms of uploading and downloading);
- lower operating costs;
- improved reliability and lower fault rates; and
- environmental benefits (*e.g,*. lower energy use).

98. It is evident that there is such a strong view on this issue in other parts of the world – including other European Member states - that decisions have already been taken that will deliver widespread FTTP networks.

99. On the other hand, there is no doubt that they are expensive to roll out at scale, and that there is a possibility that private returns may be insufficient to support their development. It is notable that governments have played a role in financing widespread FTTP deployments in some other countries.

Supporting effective competition through appropriate SMP regulation

100. While Ofcom has not considered whether the current or future market structure will deliver the type of communications infrastructure that the UK requires, a key theme of the discussion document is a consideration of how competition and investment in communications markets may evolve and the role, if any, that regulation can play in that process. This is also an important question because the conditions for investment and competition are shifting as markets transition to SFBB and to mobile broadband and services converge.

101. In Part B we explained how structural separation can improve the prospects for upstream competition and investment. In this section, we discuss more generally the various models of competition identified by Ofcom, their interplay and how the more traditional (horizontal) forms of SMP regulation can promote competition and investment.

102. While the principle of promoting competition as far upstream as is effective and sustainable remains the best way of delivering good outcomes for consumers, this does not mean that one model of competition will be effective everywhere. In fact, it is not only likely that different models will be effective under different circumstances but also that they will often coexist (as they do today) in some areas. In any event, the distinction between the various models of competition is not as clear cut as Ofcom portrays.

103. Given all this, Ofcom cannot adopt a formulaic and universal approach to promoting competition but will instead need to be more flexible and pragmatic while maintaining the principle of promoting competition as far up the value chain as is effective and sustainable.

Models of competition and promoting investment

104. In its discussion document, Ofcom considers the appropriate strategies for the promotion of effective competition and investment[36] and considers the prospects for the three types of competition that it identifies:[37]

- **End-to-end** – where vertically integrated companies such as Virgin or the Mobile Network Operators ("MNOs") build (or buy) and operate their own networks in order to compete across all parts of the value chain;
- **Access based** – predicated on regulated wholesale access to a SMP operator's network. Access can either be:
  - infrastructure based on passive inputs (for example, LLU); or
  - based on active products (for example, GEA).
- **Resale** – where providers mainly compete on marketing, billing and pricing.

105. Ofcom also explains the stark trade-offs that it considers can be made in order to promote one model of competition over another. It uses the example of its 'promotion' of LLU–based competition (*i.e.*, passive access based competition) by setting a relatively low LLU charge control while not controlling the price of IPStream (the active access product downstream of LLU) and extracting commitments from BT to maintain its IPStream prices above a certain price floor. It argues that this created the breathing space for LLU operators to enter the market and become established before BT's price floor commitment lapsed.

106. Ofcom's point is that it considers that often the promotion of one model will explicitly require the demotion of another.

107. However this portrayal is too simplistic - conditions across the UK are not uniform and this will naturally mean that different models will be better suited to different circumstances (this less certain picture is a clear difference to the situation in 2005 when the prospects for LLU based competition to develop widely were more evident). And just as happens today, it is highly likely that in many areas more than one model of competition will co-exist.

108. Above all, however, it is unrealistic to anticipate full end-to-end competition to occur in the fixed line communications sector. The reality of provision of fixed line communications services is that it is implausible that in any given area there will be a sufficient number of operators with their own networks to provide effective competition. Accordingly, some element of network sharing – whether on a co-operative basis (*e.g.*, a network sharing agreement, or joint venture) or on a regulated access basis – is always likely to be a key element in effective competition in the provision of fixed line communications services.

Promotion of competition as deep in the network as is effective and sustainable remains appropriate

109. Generally, it is desirable to promote competition as deep in the network as is effective and sustainable because exposing more of the value chain to competition can lead to greater levels of investment, innovation and cost control which in turn can lead to more choice, better products and lower prices for consumers. This is a key principle of the first TSR and remains appropriate today.

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36 Sections 9 and 10.

37 Paragraphs 9.5 to 9.7 and Figure 24.

<u>Regulated access to passive inputs will continue to play a key role</u>

110. The vast majority of the high fixed costs of communications networks (particularly fixed access networks) relate to the passive elements *e.g.*, ducts and cables. It is this part of a network that exhibits the largest scale and scope economies. Further, these passive elements often offer less scope for innovation and differentiation then the active components downstream in the network.

111. This does not mean that there are no benefits at all from exposing the passive components of networks to competition. Clearly there is some scope to differentiate network topologies, cabling and civils infrastructure. But there comes a point where the gains from competing access networks become outweighed by the cons of higher unit costs – particularly in areas where end user density is low or construction costs are high.

112. Therefore in some areas it may be more efficient for operators to share the passive components of a network (or sometimes even active networks) in order to reduce their exposure to high fixed costs and lower subscriber density. MNOs already do this with their respective network sharing agreements, MBNL and Cornerstone, and through SMP regulation LLU operators effectively share passive elements of BT's local access infrastructure. Sharing passive access can still expose the value chain downstream of this point to competition – *e.g.*, active equipment – and this is still likely to bring substantial benefits to end users (as has been the case with LLU where differentiation and innovation in active equipment was a key driver of retail competition).

113. However, often access to passive inputs would have to be required through regulation given BT's SMP in fixed local access.

114. In the context of the evolution to fibre based broadband, it is evident that upstream operators looking to deploy new fibre networks will in some instances find it only viable to do so if they could take some wholesale passive access from another local access operator – for example, Openreach. Therefore industrialised, fit-for-purpose passive access to BT's ducts, poles and cables could play an important role in fostering effective and sustainable competition in the communications sector as it transitions further to fibre.

<u>Competition based on active inputs or on resale delivers the fewest benefits but may sometimes be necessary</u>

115. Competition based on active inputs (and resale) is likely to be least beneficial to consumers because often they do not offer sufficient scope for investment and innovation downstream of that point. Communications typically benefits from competition in the active layer *e.g.*, the routers and access nodes in the access network.

116. However sometimes it is not viable for end-to-end or passive based competition to develop everywhere or for all operators. This is most likely where subscriber density is lowest (such as the most rural parts of the UK) or while there are no effective regulated upstream passive inputs (as is the case upstream of GEA today).

117. As a general principle therefore, where regulated active products are the main basis upon which competition is based, then competition and consumers will benefit most if the active products' pricing and functionality mimics as much as possible the key features of passive products and network ownership. For example:

- price structures could reflect the characteristics of network economics such as high fixed costs and low variable costs (an approach commonly adopted by regulators when imposing MVNO remedies in mobile merger cases); and
- technical functionality that gives full service control to the downstream operator.

118. A key weakness with GEA today and a reason why Openreach's external customers have been relatively slow to adopt it is that is does not have these features.

Different models of competition can co-exist, they are not mutually exclusive

119. In practice, it is unlikely that just one model of competition will be effective everywhere and it will be appropriate for Ofcom to support all models to a varying degree dependent on circumstances (which are not uniform throughout the UK).

120. Ofcom argues that this can be problematic if the promotion of one model requires the demotion of another. For example, promotion of full end-to-end competition could entail the removal or relaxation of access based regulation. In these circumstances Ofcom will need to consider carefully which model is most likely to deliver long term sustainable benefits to consumers.

121. However different models of competition are not mutually exclusive. Indeed, they already co-exist. For example, competition from operators with their own networks (in the form of cable) and access based competition (in the form of LLU operators) have co-existed sustainably and effectively for many years. The combination of the two competition models for a large proportion of the country has been instrumental in delivering choice and low prices for consumers.

It may be appropriate not to price control risky new investments at first

122. Ofcom considers that it may be appropriate to not control the prices of BT's wholesale access products in order to promote investment by both BT and by new entrants and that this approach could provide the necessary incentive for more risky network investments to be made.[38] Undoubtedly, it is important to preserve investment incentives and regulatory pricing forbearance can be an effective mechanism by which to achieve this aim.

123. Generally, where the investment and the risk are significant Sky supports this approach. There is a need however to discern carefully the relative riskiness of network investments and to not merely categorise every network upgrade (or phase of an upgrade) as bearing the same significant risk and therefore applying the same regulatory remedy (or none at all).

124. For instance, when BT embarked on its FTTC roll out in 2008/9 there was considerable risk – particularly on the demand side – but as the six year roll out programme developed and further investments were made the risk would have subsided significantly as deployment costs and demand became more certain. For this type of investment, early expenditure was exposed to considerably more risk than roll out expenditure in the final years.

125. Therefore not all of the new investment necessarily should be immune from being subject to a charge control at some point. Going back to the example of GEA, it may now be appropriate to consider the imposition of a charge control at the next market review.

126. Ofcom's approach to the question of whether to apply a charge control to new investments will depend on the specific circumstances. The key objective will be to preserve investment incentives while protecting consumers and downstream CPs (whose investment incentives are also important) from excessive prices for mainstream services.

127. There is a degree of flexibility in how price controls could be introduced should it be considered appropriate to regulate the price of the new investment but where there are persistent concerns that investment incentives would be undermined if prices reflected ongoing costs immediately.

38 Figure 28.

128. Most obviously, the use of a CPI-X glide path in a charge control means that prices do not typically match forecast costs until the end of the charge control period (*i.e.*, after three years). If the prices for the new investment prior to the application of the charge control were significantly above ongoing costs then this could allow the SMP operator substantial additional returns for an extended period. There are also various other charge control mechanisms that can be applied in order to maintain investment incentives including the use of risk premia[39], application of real options theory, anchor product pricing, and cost orientation (as opposed to CPI-X price controls).

Controlling unduly excessive returns on price regulated products

129. It is not only weaknesses with the Undertakings that have contributed to the competition problems now besetting the industry. It is also evident that aspects of Ofcom's approach to the more traditional forms of SMP regulation – such a price controls – have also played a role. Therefore it is appropriate to take stock at this review and consider whether the current approach to charge controls is the right one.

130. Ofcom acknowledges that BT has earnt billions of pounds in additional profits over and above its cost of capital on products where Ofcom has set the price. This has occurred at a time when Openreach has under-invested in its underlying network and service quality has fallen. Ofcom goes on to consider whether these additional returns are justified.

131. Ofcom argues that:

- two thirds of these additional profits relate to its policy decisions – such as those to set higher regulated prices in order to promote dynamic efficiency through market entry and / or investment; and
- the remaining excess returns stem from BT reducing its costs by more than forecast when the charge controls were originally set. Ofcom argues that this additional efficiency is beneficial to consumers and CPs in the long run because subsequent charge controls will reflect BT's lower starting costs and prices will be lower as a result.

132. Ofcom places great store in the principle of the 'fair bet' where the regulated firm is incentivised to invest or to be more efficient by the opportunity to earn higher returns (than its cost of capital). In principle, this is reasonable and in practice this approach has likely delivered benefits in the form of lower regulated prices in the long run. However, there are also substantial problems with Ofcom's approach:

- **The bet appears to be loaded in BT's favour and does not need to be** – for the bet to be a fair one, as accepted by Ofcom, "[t]*he potential for higher returns balances out the possibility of returns below the cost of capital.*"[40] But, instead, overall BT has consistently and systematically made returns on its price regulated services well above its cost of capital – even where Ofcom has not deliberately sought to set prices above costs. This suggests that the charge controls have been insufficiently ambitious leading to a situation where BT can comfortably generate excess profits while consumers pay far too much and competition suffers. While BT has been incentivised to be more efficient than forecast in order to make more profits, its incentives would be no weaker had the charge controls been more challenging.
- **Reducing service quality is equivalent to raising prices and undermines the objective of the charge control** – substantial additional profits have often been

39 Risk premia can be reflected by adopting a higher cost of capital in the charge control formula.

40 Paragraph 4.60.

generated by BT cutting back on service quality. All else equal, a reduction in the quality of a product is equivalent to raising prices. Therefore in the context of 'CPI-X' charge controls (the common form adopted by Ofcom), should BT reduce service quality in order to reduce its costs more quickly than forecast by Ofcom so that it can make higher returns (as it is incentivised to do), this would effectively circumvent the purpose of charge control. Put another way, while headline prices may fall at the required rate, CPs are receiving an inferior product than before implying that the underlying (or real) price reduction is either not as large or in fact a price increase. Perversely, Ofcom then requires CPs to pay Openreach for the additional costs involved in raising quality standards back to where they were.

- **The policy is undermined by inappropriate cost allocations** – Sky fully appreciates the benefits of BT being more efficient and the role that charge controls can play in promoting efficiency. However, the large discretion BT is afforded in the preparation of its regulatory accounts coupled with BT's high fixed and common costs means that it is far from clear whether lower costs are a result of efficiency or a change in cost allocation methodology.

- **Insufficient scrutiny of whether the benefits of promoting market entry or investment outweighed the harm from higher prices** – whereas promoting dynamic efficiency can be beneficial (*e.g.*, by requiring BT to maintain higher wholesale broadband access prices in order to support LLU based competition), benefits to consumers and competition are not always clear cut and may be outweighed by the harm caused by allowing higher prices for regulated products (*e.g.*, Ofcom's policies of (i) setting high price caps for ISDN30 or of (ii) not setting charge controls at all for AISBO services between 2006 – 09) . Moreover, setting higher prices for SMP services in order to promote entry should only be temporary as either: (i) there is effective and sustainable market entry such that BT is no longer dominant and there is no need for price controls or (ii) there has been limited entry and it would be no longer appropriate to maintain artificially high prices as sustainable competition eventually needs to be based on more statically efficient prices. Given that the additional costs incurred by industry, businesses and consumers are substantial – according to Ofcom, over £2.5bn since 2006 (two thirds of its estimate of £4bn in additional profits) – a more rigorous and consistent cost benefit analysis of Ofcom's policies of promoting investment and market entry is required. An objective assessment is likely to provide valuable insight that can inform future policy decisions and therefore should form a key part of the SRDC.

- **The negative wider impact of excess profits** – while Ofcom narrowly and speculatively weighs the merits of higher regulated prices against future gains from increased efficiency, more investment and market entry it fails to consider the broader effect of allowing (predominantly) Openreach to earn high margins. Ofcom's approach means that Openreach generates high margins and free cash flow to BT Group. This has led it to be treated as increasingly a 'cash cow' with supressed investment levels by BT.

133. On balance, while the principle of promoting investment, efficiency and market entry by allowing higher returns is a good one, it is evident that its practical application allows BT too much scope to earn excess profits without concomitant benefits to consumers. For instance, the system cannot be working properly if BT can earn between £4bn - £5.5bn in excess profits since 2006 while simultaneously degrading service quality (which effectively constitutes a price rise) and then be paid (through higher regulated charges) to restore service quality to previous levels.

134. Going forward it is appropriate to consider:

- setting more demanding charge controls that require steeper price reductions;
- undertaking more enforcement action *e.g.*, fines to address BT's serial manipulation of its regulatory financial accounting; and
- while BT can and should improve service quality without increasing its costs, should it make quality improving investments then they should be self-funded from its substantial additional returns.

The requirement for regulation to drive significant improvements in Openreach's quality of service

135. Ofcom recognises, correctly, that Openreach service performance is a core strategic concern and that it is resulting in poor business and consumer outcomes. Not only do quality of service issues affect consumers and businesses directly, they also dampen consumer switching which favours BT as it has the largest subscriber base and the most to gain from inert consumers. As a result, poor service quality adversely affects competition.

136. In Part B of this response, we have explained how structural separation and the resulting contestability of BT Retail's business could lead to Openreach improving its service quality. Irrespective of whether structural separation takes place or not, however, there is a strong requirement for Ofcom to place greater emphasis on driving improvements in service quality through regulation.

137. It is worth noting that one of the many benefits of separating Openreach from the rest of BT is that regulation would become far simpler, less burdensome and more focused. In that context with layers of behavioural regulation stripped away, Ofcom and Openreach would be able to give service quality the full attention it deserves thus making regulation of it more manageable and effective.

138. The SRDC enables Ofcom to set clear expectations and a framework for improved Openreach service performance which can then be implemented as part of Ofcom's periodic market reviews.

<u>Evidence of Openreach's poor service performance</u>

139. Evidence of Openreach poor service performance has been provided as part of Sky's Initial Submission[41] and is also summarised in Part A above. Essentially, Openreach's performance falls far short of an acceptable standard, including: an excessive number of faults, failure to meet targets for repairing faults, long waits for new line installations, and when appointments are met, jobs are often not completed or consumers experience faults with the line immediately after the installation (so-called Early Life Failures or ELFs).

140. Sky's experience echoes Ofcom's initial findings in the SRDC discussion document which identified poor quality outcomes in provisioning and repair.[42]

<u>Driving real improvement through effective regulation and enforcement</u>

141. It is well recognised that, when regulating firms with significant market power, it is necessary to regulate charges and service quality together. The predictable result of regulating price but not regulating quality is that the entity with market power will seek to increase profits by reducing the quality of service it delivers.

142. Until recently, Ofcom hoped that the requirement for Openreach to deliver inputs on a non-discriminatory basis would address this issue. It was thought that, if Openreach was

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[41] Annex 1 of Sky's Initial Submission.

[42] Paragraphs 13.43 - 13.46.

delivering a good quality of service to BT's retail division, the equality of input requirement would mean that a good quality of service would be delivered to all. Experience has, however, shown that this approach cannot be relied upon.

143. While Ofcom has now clearly recognised the need to regulate service quality, which Sky welcomes, in Sky's view that recognition is inadequate in two respects.

144. First, Ofcom needs to recognise that it has a key role in driving Openreach to deliver step changes in its service delivery over time. Ofcom's role here is analogous to the role that it plays in relation to setting charge caps. In that area, Ofcom devotes substantial resources to determining what is achievable on a forward-looking basis in terms of reductions in cost, and therefore charges, over the course of a charge control period. Once Ofcom sets charge caps, however, the task of meeting those caps is BT's responsibility – Ofcom has no role to play in determining *how* BT achieves the necessary cost savings in order to meet the charge caps.

145. Ofcom must embrace a similar role in relation to quality of service – seeking to determine the service quality levels that it should be expected that a 'best in class' operator would deliver, and requiring Openreach to achieve that standard. Again, however, the way in which Openreach decides to meet any such standards must be for BT to determine.

146. It is not sufficient for Ofcom simply to aim for service quality standards that BT has demonstrated that it has been able to meet in the past. Such an approach does not conform to Ofcom's duty to further the interests of consumers.

147. Second, Ofcom should abandon its presumption that improvements in service quality can *only* be achieved by providing Openreach with additional resources, and therefore require higher wholesale charges.

148. There is widespread experience among firms, in many sectors, of programmes that are focused on delivering improved service quality to customers. One of the key principles of such programmes is that often that can be delivered within existing budgets – for example, by adopting more intelligent ways of working, or organisational change – or even be cost-reducing. This point was raised by Sky in its response to Ofcom's FAMR consultation (dated 19 December 2013, Section 2(B)), as follows:

> "*2.20 In the past ten years transformation programmes among firms undertaking operational tasks similar to those undertaken by Openreach have become relatively common, both in the UK and other countries. These are firms where the core task is the effective and efficient management of (a) a large field force and (b) network assets, in order to deliver high quality services to end-users, often under significant time and cost pressures. The focus of such programmes normally is to improve service delivery significantly, while at the same time reducing costs. In the past five years in the UK some of the firms that have undertaken significant field force transformation programmes include:*
>
> - *EDF Energy*
> - *npower*
> - *Scottish Power*
> - *SSE (Scottish & Southern Energy)*
> - *Thames Water*
> - *UK Power Networks*
> - *Virgin Media*

> *2.21 Indeed, as Ofcom is aware from the Sky presentation given in September 2013, Sky itself has undertaken such a programme, with highly positive results."*
>
> *2.22 The consistent experience is that such programmes, when undertaken in a holistic and committed way, are able to deliver significant gains in service delivery, often at the same time as reducing costs."*

149. A presumption that the only way that service quality can be improved is via increased resources and cost is wholly inappropriate.

150. Even if *in extremis* it were considered unavoidable for Openreach to raise its costs in order to make improvements in service quality, there remains a legitimate question as to whether it would be appropriate for those additional costs to be recovered through regulated charges. One purpose of any charge control is to give the regulated firm an opportunity to recover its efficiently incurred costs and it could be considered that investments made to bring service performance up to an acceptable level are not efficient (or at least would not be incurred by an efficient operator).

151. In Openreach's case, its poor quality levels have been, at least in part, caused by its own under-investment in the underlying copper and duct network in order to manage the roll out of FTTC without increasing its total capital investment. During this time Openreach has remained highly profitable and has earnt billions of pounds in profits in excess of its cost of capital despite most of its products and services being subject to regulatory charge controls. Requiring Openreach's customers to fund service improvements through higher regulated charges is particularly egregious in this context.

152. Self-funding by BT of quality of service improvements should be Ofcom's starting point. There is ample scope for Openreach to fund and deliver significant, sustained improvements in quality of service.

153. In the SRDC discussion document, however, in keeping with its approach in the FAMR, Ofcom asks for stakeholder views on CP or consumer willingness to pay for improved performance.[43] This approach reflects the false premise that improved service delivery can only be achieved by adding more resources, and therefore requiring higher charges.

154. Ofcom has also identified a range of other policy options to seek to improve quality of service including: (i) relying on end-to-end network competition, (ii) greater transparency and publication of information for consumers on service quality, (iii) facilitating industry negotiations to promote best practice and (iv) setting requirements to treat customers equally.[44] None of these (individually or taken together) are sufficient.

- **Limited end-to-end network competition will not deliver improved performance by itself** - as long as the end-to-end competition as summarised by Ofcom from Virgin Media and other smaller alternative network providers (CityFibre, Gigaclear, B4RN and Hyperoptic) remains limited, the scope for network competition to incentivise Openreach (with the only ubiquitous fixed telecoms network in the UK) to improve its service performance materially remains low[45] - particularly in areas where there is no competing infrastructure.

- **Information remedies will do little to address underlying performance** – it is essential for CPs to be provided with full transparency of Openreach service performance and therefore any additional measures that provide CPs with greater information would be helpful. However these measures will do little to improve

43 Paragraph 13.40.

44 Figure 38 and paragraphs 13.47-13.62.

45 Figure 25, page 89.

underlying performance levels. For example, the OTA2 publishes details of Openreach provisioning and repair performance against KPIs but this does not impact the minimum performance levels or result in real improvement.[46]

- **OTA2 facilitated negotiations do not replace the need for Ofcom to intervene** - Ofcom has also taken steps to facilitate improved industry negotiations via the OTA2. However, these measures have done little to address the asymmetric bargaining position of the parties given BT's SMP. The new measures have clarified the role of the OTA2 but do not resolve the underlying issue of the lack of countervailing buyer power of the negotiating CPs and the need for negotiation failures to be escalated to Ofcom. It would be more efficient if the OTA2 could opine on issues rather than simply observing the conduct of the negotiations and leaving the unresolved issues to be referred to Ofcom.

- **Requiring Openreach to treat all customers equally does not improve service quality** - Openreach is already required to provide its products and services to all CPs (including downstream divisions) on an EoI basis but service quality remains poor. As noted above, the idea from the first TSR was that service quality would improve for all because downstream BT divisions would demand improved quality from Openreach and that any resulting improvements – as a result of EoI – would be extended to all CPs. However, instead of incentivising Openreach to deliver an equally good service to all, the reality is that Openreach has delivered an equally poor service to all CPs and EoI has had no success in delivering higher service quality.

Ofcom will need to revisit its conclusions from the review if the merger of BT and EE goes ahead

155. The consideration of ongoing regulation in the discussion document is predicated, implicitly, on a scenario in which BT and EE remain as separate operators. If the proposed merger of the two companies proceeds, with or without remedies, it will have significant implications for both the UK telecommunications sector[47], and Ofcom regulation.[48] Accordingly, while it is sensible to proceed currently on the basis of the *status quo ante*, Ofcom should signal that it will need to revisit the conclusions of its review if the merger goes ahead.

Consumer Issues

156. In its introduction to the review, Ofcom identifies as one of its four main *"areas of strategic challenge"*[49] the issue of *"Empowered consumers, able to take advantage of competitive markets"*[50]. Section 12 of the discussion document considers Ofcom's current approach to empowering consumers (focusing on consumer access to information and consumers' ability to switch) and the questions of whether this approach might need to be adapted and more done for consumers on this front.

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46 See, for example: 'Key Performance Indicator September 2015' - http://www.offta.org.uk/charts.htm.

47 The merger would bring together BT, the UK's largest fixed operator and infrastructure owner with EE, the UK's largest MNO to create the UK's largest CP by a considerable margin.

48 BT's enhanced ability and incentives to distort downstream competition in fixed broadband and mobile backhaul would put further strain on the existing regulatory regime, rendering it unfit for purpose. BT's distortive incentives in fixed will be extended into new areas – into mobile, increasingly fixed-mobile services as take up of these increases, and into small cell networks, where there is no existing regulation.

49 Paragraph 2.4.

50 Paragraph 2.5.

157. Sky considers that the starting point for Ofcom's consideration of this issue should be to ask, given the resource constraints Ofcom faces, whether such issues merit growing attention from Ofcom, particularly given the extent of the difficult issues raised elsewhere within Ofcom's remit. In terms of administrative priority, there are steps that Ofcom can take in relation to these other difficult issues (such as improving Openreach service quality) which will be far more productive in empowering consumers to engage in communications markets.

158. Sky agrees with Ofcom's broad objectives in relation to consumer issues: to enable consumers easily to find products and services that best meet their needs, and to switch suppliers easily if they wish. There is always scope for improvement in relation to such issues. However, such improvements are an ideal candidate for targeted intervention, rather than an expansive regulatory agenda.

159. In general, Sky considers that consumer issues is an area where Ofcom should seek to do less over time. Ofcom rightly identifies 'consumer empowerment' as the litmus test for whether consumers are likely to be well served in the UK communications sector. The fact is, however, that UK consumers are more empowered to exercise choice than ever before:

- competition is a key enabler of consumer empowerment. Accordingly, addressing competition issues in the sector makes a fundamental contribution to empowered consumers;
- consumers have a vast range of information available to them about products and services available in the communications sector – from suppliers, comparison websites, other consumers (*e.g.*, online via blogs and forums), friends and family, and from Ofcom. Consumers are therefore readily able to find and compare different products and services;
- switching is straightforward. Millions of UK consumers switch providers within the broad communications sector every year and evidence indicates consistently that for the vast majority switching is hassle-free with many residual concerns relating to Openreach's poor quality of service;
- levels of consumer satisfaction in the sector are high; and
- the communications sector is already heavily regulated, particularly in relation to consumer rights and the provision of information to consumers. Ofcom already has at its disposal an arsenal of sector-specific powers and general consumer law with which to protect consumers at all points in the customer journey, from advertising to termination. If anything, over-regulation in this area risks dis-empowering consumers by overloading them with so much consumer regulation information that none of it is properly digested.

160. In the circumstances, Sky urges Ofcom not to divert resources to increased activity in this area when they could be used more productively elsewhere to empower consumers.

Sky **October 2015**

ANNEX 1

"*Possible concerns from bundling content and telecoms services*"

1. In Section 9 of the consultation, Ofcom discusses "*possible concerns from bundling content and telecoms services*".[51] These concerns are unfounded.

2. At the outset, Sky notes that there is a common misconception about the extent and nature of bundling of telecoms and pay TV services in the UK. In Sky's case, in particular, pay TV and telecoms services are not sold as a pure bundle – *i.e.*, as a single product for a monthly subscription charge. They are sold, and billed, separately, with customers entering separate contracts with Sky for the two types of service.

3. This is particularly relevant to the discussion in Section 9 of the consultation as, with the development of over the top ("OTT") pay TV services, it is increasingly possible for consumers to 'self-assemble' bundles. For example, it is straightforward for a household to be a BT or Virgin Media customer for telecoms services and to subscribe to Netflix, Amazon Prime or NOW TV for pay TV services (as well as being able to access on-demand services from a range of providers, such as Apple, Google Play and Sky Store).

4. More generally, both (i) the nature of content generally being sold in conjunction with telecoms services, and (ii) the focus of firms' efforts in relation to selling 'bundles' also are often misunderstood. In relation to the first of these matters, it is important to note that 'premium channels' (*i.e.*, pay TV channels sold as add-ons to basic pay TV packages) play a relatively minor role; aside from the unusual circumstances relating to BT Sport[52], sales of pay TV services by BT and TalkTalk – the new entrants to the provision of bundles of pay TV and telephony – are dominated by basic pay TV packages.

5. Second, the principal focus of telecoms operators' sales efforts is on up-selling their own existing customer bases, in order to increase ARPU and potentially reduce churn. For example, TalkTalk's results announcement for the year to March 2014 indicated that two thirds of sales of its TV service were to existing TalkTalk customers. TalkTalk also stated:

> "*At the end of the year, just over 25% of our fully unbundled customers were triple-play. We expect to add a similar number of TV customers in FY15 as we did in FY14, which would take penetration to nearly 40% of our on-net base. Our primary target market remains the large base of Freeview households in the UK (c18m) and we continue to expect that in time nearly all of our on-net customers will convert to triple play in line with increasing recognition of the convenience and value of bundling, and as we drive increased awareness of our compelling content offer.*"[53]

6. These points provide important contextual background to the issues raised by Ofcom in relation to content. In particular, in this context, the focus on issues related to (a) access to premium content, and (b) third parties' platforms in Section 9 of the consultation are of little relevance to the realities of bundling of telecoms and pay TV services in the UK both currently and in the foreseeable future.

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[51] Paragraph 9.93 *et seq.*

[52] These circumstances are unusual because BT has adopted a strategy of providing its sports channels to telecoms customers for free.

[53] 'TalkTalk Telecom Group PLC - Preliminary results for the 12 months to 31 March 2014 (FY14*)*, Full Press Release', 15 May 2014 - http://www.talktalkgroup.com/~/media/Files/T/TalkTalk-Group/pdfs/reports/2014/preliminary-results-fy14.pdf.

There are no enduring bottleneck issues in content provision

7. One of the key issues raised in Ofcom's discussion of content issues in the consultation is whether there are "*enduring economic bottlenecks in the provision of content*", such that competition problems arise that affect the ability of retail providers to compete effectively for customers who wish to purchase pay TV and telecoms services from the same supplier.[54]

8. Access networks are a classic example of an enduring economic bottleneck. They comprise long-lived physical assets which are difficult to replicate economically, and which exhibit natural monopoly characteristics. They are normally owned by a single firm, in perpetuity.

9. The circumstances of content provision, however, could not be more different. At the furthest upstream (rights) level, there is a plethora of different types of content available, produced, or owned, by an enormous range of entities. Whilst content owners typically have perpetual ownership of their assets, they are normally exploited via relatively short-term intellectual property licences (typically of 3 to 5 years duration), for which there is intense competition. It is in the interests of rights owners to ensure that there is strong competition for their rights. Many types of content are highly replicable.

10. Downstream of rights owners, there is no evidence to suggest that there are any enduring issues associated with distribution of content which might give rise to bottleneck concerns. In relation to sports content, the substantial fixed costs associated with licensing sports rights (particularly rights to events that consumers have a high willingness to pay to view) gives rise to powerful incentives to distribute that content widely, and Sky is a willing supplier of its channels to third parties.[55] Allegations that Sky's distribution strategy for its sports channels is motivated by anything other than normal commercial considerations were rejected comprehensively by the Competition Appeal Tribunal in 2012.

11. In relation to other types of content, such as movies and general entertainment, while there is equally little reason to be concerned about distribution of that content, issues of non-replicability are also far less pronounced. In the specific case of movies, the extent of exclusivity is also significantly less than in relation to sports and general entertainment content. This means that providers of telecoms services have a range of alternative ways that they can deliver movies to their customers – notably via transactional VOD services (the rights to which are overwhelmingly non-exclusive) which are often better suited to delivery via telecoms networks than linear television channels, and provide movies in an earlier window than Sky's movie channels – a point that is often cited in their marketing.

12. Ofcom's brief discussion of movies also fails to recognise that one of the fundamental reasons that the Competition Commission concluded that no action was necessary in relation to movies on pay TV channels was that it found that neither movies in general[56] nor Sky's movie channels in particular[57] could, today, be regarded as 'significant' in relation to the provision of pay TV services.[58] These findings were supported by a broad range of relevant evidence.

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[54] Paragraph 9.126.

[55] These issues are discussed in greater detail in Sky's response to the December 2014 WMO Review consultation.

[56] See, for example, paragraph 6.24 of the Competition Commission's report.

[57] See, for example, paragraph 6.57 of the Competition Commission's report.

[58] Ofcom cites only paragraph 6.7 of the Competition Commission's report, which does not contain significant findings.

"Access to platforms"

13. Section 9 of the consultation also considers the issue of whether retailers of pay TV services are able to gain "*access to platforms and devices*".[59] Again, it would be impossible for Ofcom to conclude, on the facts, that platform access issues give rise to concerns in relation to bundling of TV and telecoms services.

14. Sky notes at the outset that issues of access to third parties' platforms are really only relevant to the strategic review in the specific case of a telecoms operator that becomes vertically integrated into pay TV broadcasting – as BT has done. It would be highly unusual for a telecoms operator which was not also a pay TV broadcaster to seek to retail pay TV services, bundled with its own telecoms services, on a third party's platform. Normally one of the key reasons for a telecoms operator extending its activities into pay TV retailing is to drive customers and/or usage to its own network – *i.e.*, to take advantage of economies of scope in network provision. This is the observed pattern of development not only in the UK (for example, in relation to cable networks, and IPTV operators such as TalkTalk), but also around the world.

15. As Ofcom notes, correctly, technological change has meant that there is now a plethora of ways in which a telecom operator seeking to offer pay TV services to its customers can do so; barriers to developing, launching and operating new platforms are low.

16. In the highly specific case of telecoms operators that choose to extend their activities into pay TV broadcasting, it does not necessarily follow that they require access to third parties' platforms; it is plainly open to them to agree wholesale deals with third parties. This is what has happened, for example, in relation to BT and Virgin Media, where BT has no ability to retail its channels directly to the circa 4 million households on Virgin Media's cable platform. There is currently only one TV platform in the UK on which telecoms operators that have extended into pay TV broadcasting have a choice of retailing their channels if they wish guaranteed by regulation, namely Sky's DTH satellite platform. The example of BT – and other operators previously, such as Setanta – show that the open access regime in relation to Sky's DTH satellite platform operates effectively.[60]

17. Sky is perplexed by the purpose and meaning of paragraph 9.121, which refers to the 'vicious circle' proposition (labelled in paragraph 9.121 as a 'virtuous circle'). That hypothetical proposition has now been thoroughly discredited in the context of incentives to restrict distribution of content, and was rejected by Ofcom in its 2010 Pay TV Statement in relation to the issue of barriers to entry at the wholesale level in the pay TV sector. It is hard to see how the issue relates to the issue of bundling of pay TV and telecoms services.

The current regulatory toolkit is sufficient

18. Ofcom concludes Section 9 by asking whether "*our various regulatory tools are appropriate to enable us to address any competition concerns across the services which make up the retail bundle*".[61] The answer to this question is, plainly, in the affirmative.

19. The normal way in which "*competition concerns*" are addressed in the economy generally is via the application of competition law. There is no good reason to believe that UK competition law is, in some way, unable to deal effectively with any competition concerns

59 Paragraph 9.119.

60 At paragraph 9.119 Ofcom appears to insinuate that this regime may not have worked effectively, stating "*platform access concerns have previously arisen in the case of linear channel providers looking to secure access to Sky's platform.*" This statement is unfounded.

61 Paragraph 1.65.

that arise in relation to content issues. The UK competition regime is regarded as being one of the best in the world, and was strengthened in 2013. It provides for significant penalties for anti-competitive behaviour, and, as discussed in the main body of this response, has a 'market investigation' regime, that can be used to examine markets in which competition is considered not to be working well, and to implement potentially significant remedies. The types of competition issues that potentially arise in content markets are well-trodden ground in competition law; there is nothing unusual about content markets in terms of competition issues.

20. Ofcom also has concurrent powers with the CMA to apply general competition law to the audiovisual sector, and has separate, sector-specific additional competition, set out in Section 316 of the Communications Act. In addition, Ofcom has competition-related powers to regulate access to platforms and electronic programme guides.

21. There is no credible case that this suite of existing legislation and regulation is insufficient to address competition issues related to content, insofar as they relate to its provision to customers in conjunction with communications services (or, indeed, more generally).