

THE IMPACT OF A COST-BASED VULA PRICE

September 2016



EXECUTIVE SUMMARY

A significant proportion of consumers in the competitive UK consumer broadband market are served by companies such as TalkTalk and Sky which rely on regulated access to BT Openreach's network to deliver broadband products to consumers and small businesses. Ofcom has required BT to provide Virtual Unbundled Local Access (VULA) products which give access to Openreach's fibre based network, allowing retail rivals to BT to offer 'superfast' broadband (SFBB). As consumers increasingly migrate to SFBB, the pricing of VULA products is having an increasingly important impact on consumer welfare.

To date, Ofcom has provided BT with considerable flexibility in how it sets its VULA prices. In particular, BT faces no direct regulatory restriction on how high it sets the VULA price, subject to the margin between BT's retail prices and the VULA price being sufficient to allow other players to compete.

As part of the Wholesale Local Access market review, Ofcom is currently deciding how to regulate VULA products from 2017 onwards. In light of this, TalkTalk has asked us to evaluate the impact for consumers from moving to a cost based price for VULA, through lower retail prices increasing consumer welfare. Based on the relevant costs reported by BT, this would lead to a significant reduction in the wholesale VULA price compared to the current situation where Ofcom provides BT with pricing flexibility. Our analysis of BT's cost data¹ suggests that an immediate move to a cost-based price would result in the wholesale price for SFBB falling from £7.6 per month to around £3 per month.

To estimate the impact of this price reduction on market outcomes, we have used an economic model² often used to analyse oligopolistic markets, such as the UK market for broadband³. The approach captures the competitive reactions of all players in the market, both those who would directly benefit from a reduction in the VULA price such as TalkTalk and Sky, but also those that would have to react to reductions in retail prices caused by the reduction in the VULA price, such as BT and Virgin.

Based on our analysis, the VULA price reduction is likely to have a number of impacts for UK consumers and some small businesses:

- **Lower SFBB retail prices.** As TalkTalk and other access based retail competitors would face lower input prices, they would be expected to reduce their retail prices, which would benefit their SFBB subscribers. This lower level of retail prices would also lead to BT and Virgin Media setting their SFBB retail prices at a lower level in response, even though they would not be directly affected by the VULA price cut. Our analysis suggests that the average retail SFBB prices across the market would be lower by 5.5% by the end of the next market review period, compared to a 'status quo' scenario where prices remain at today's level (in real terms).

¹ This is estimated without access to BT's detailed financial information.

² A differentiated Bertrand model.

³ Similar models have been used by the European Commission to analyse mobile markets, when assessing the impact of mobile consolidation in markets with a similar number of players.

- **Faster migration to SFBB.** As a result of the lower level of SFBB retail prices, consumers will be expected to migrate more quickly from SBB to SFBB. This will benefit those consumers who switch, given that SFBB is a higher quality product. Our analysis shows that an additional 400,000 households would switch to SFBB by the end of the next market review period (2019/20) as a result of moving to a cost-based SFBB wholesale price.

Our analysis allows us also to quantify the increase in consumer welfare from moving to a cost-based VULA price, which we estimate to be in the region of £8.1bn over a 9 year period.

