Body of European Regulators
for Electronic Communications

BoR (13) 94

BEREC Opinion on

Phase II investigation

pursuant to Article 7a of Directive 2002/21/EC as amended by Directive 2009/140/EC:

Case DE/2013/1460

Call termination on individual public telephone networks provided at a fixed location (market 3) in Germany

1 August 2013

Contents

1. EXECUTIVE SUMMARY

On 21 May 2013, the Commission registered a notification from the German national regulatory authority, Bundesnetzagentur (BNetzA), concerning the market for call termination on individual public telephone networks provided at a fixed location in Germany (corresponding to market 3 in Commission Recommendation 2007/879/EC of 17 December 2007).

In the present notified draft measures, BNetzA proposes to impose on two alternative operators[1] having SMP on the fixed termination market the following obligations: (i) obligations to provide interconnection and termination services, (ii) co-location obligation for interconnection purposes, including the obligation to give colocation users access to facilities at all times, (iii) obligation to ensure that access agreements are based on objective criteria, are transparent, grant equally good access and meet the requirements of fairness and reasonableness, (iv) obligations to publish technical specifications, network characteristics, conditions of provision and the rates for interconnection and termination services, (v) obligation to submit the access agreements to BNetzA and (vi) price control obligations by way of setting symmetrical rates through a benchmarking method based on the proposed fixed termination rates (FTR) of Telekom Deutschland GmbH (DT) as notified under case DE/2013/1430[2].

Except for these two SMP operators, all designated SMP operators in the fixed voice call termination markets have committed to charge in reciprocity the provisional termination rates of DT as of 1 December 2012. The present notified draft measures on the two SMP operators may be considered as a model for all other alternative operators.

On 20 June 2013 the Commission sent a serious doubts letter opening a phase II investigation pursuant to Article 7a of Directive 2002/21/EC as amended by Directive 2009/140/EC. Commission's doubts relates to the compatibility with EU law of BNetzA's proposed measures concerning price control remedies for the wholesale markets for call termination on individual public telephone networks at fixed locations in its current form, due to the methodology used to calculate the costs of services.

In particular, the Commission expressed serious doubts as to the compatibility of the draft measures with the requirements of the Article 8(4) and 13(2) of the Access Directive in

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[1] [netzquadrat] Gesellschaft für Telekommunikation mbH and T & Q Netzbetriebs GmbH.

[2] BNetzA notified to the Commission under case DE/2013/1430 its draft measures concerning remedies to be imposed on DT. In these draft measure, BNetzA proposes to impose among others the following obligations: interconnection and conveyance obligation, co-location obligation for interconnection purposes and price control obligation with rates which, in BNetzA's view are calculated based on LRAIC+ cost methodology. The Commission expressed its serious doubts as to the compatibility of the proposals with EU law concerning the price control remedies for call termination, due to the methodology used to calculate the costs of services. On 17 May 2013, BEREC issued an opinion considering that the Commission's serious doubts are justified in that BNetzA's proposed FTRs are not based on a pure LRIC costing methodology and no valid justification has been provided for such deviation.

conjunction with Article 8 and Article 16(4) of the Framework Directive. The Commission also considered that the measures contained in the draft decision may create barriers to the internal market.

BEREC considers that under Article 19 of the Framework Directive, an NRA can deviate from a recommendation, here the Commission Recommendation 2009/396/EC on the Regulatory Treatment of Fixed and Mobile Termination Rates (hereinafter referred to as the "Termination Rates Recommendation"), under the condition that it informs the Commission giving the reasons for its position.

On the basis of the analysis set out in this Opinion and in equivalence to BEREC opinion[3] issued concerning BNetzA's proposed FTRs of DT BEREC considers that the Commission's serious doubts are justified in that BNetzA's proposed FTRs by national benchmarking to the rates of DT are not based on a pure LRIC costing methodology and no valid justification has been provided for such deviation.

In BEREC's opinion, BNetzA has not provided valid justifications to deviate from the Termination Rates Recommendation. In particular, BNetzA has neither proved that the potential impacts of applying pure BU-LRIC based tariffs on German operators and/or consumers would justify a departure from pure BU-LRIC, nor has it proved that its proposal would be better suited to meet the policy objectives of promoting efficiency and sustainable competition and maximize consumer benefits than the recommended pure LRIC one.

In addition, BEREC shares the Commission's serious doubts that BNetzA proposal could create barriers to the internal market as BNetzA's proposals are based on an alternative methodology to that recommended by the Commission without valid justification, whose application leads to significantly higher FTR in Germany as compared with the average pure BU LRIC tariffs of other countries that have set tariffs based on pure LRIC (via a bottom-up model or benchmark).

BEREC suggests that BNetzA sets the fixed termination rates for these two alternative SMP operators and to all designated SMP operators in the fixed voice call termination markets at the level of pure BU-LRIC costs.

2. INTRODUCTION

On 21 May 2013, the Commission registered a notification from the German national regulatory authority, Bundesnetzagentur (BNetzA), concerning the market for call termination on individual public telephone networks provided at a fixed location in Germany (corresponding to market 3 in Commission Recommendation 2007/879/EC of 17 December 2007). On 31 May 2013, a request for information (RFI) was sent to BNetzA and responses were received on 5 June and 11 June 2013.

The Commission initiated a phase II investigation, pursuant to Article 7a of Directive 2002/21/EC as amended by Directive 2009/140/EC, with a serious doubts letter on 20 June 2013. In accordance with the BEREC rules of procedure the Expert Working Group (EWG)

[3] BoR (13)55

was established immediately after that date with the mandate to prepare an independent BEREC opinion on the justification of the Commission's serious doubts on the case.

The EWG met on 5 July 2013 in Riga with the objective to share understanding on the notified documents and decide whether, based on the information available thus far, it could reach clear conclusions on whether or not the Commission's serious doubts are justified. The EWG reached preliminary conclusions on the issues by the analysis of the relevant documents.

The EWG held a conference call with BNetzA on 5 July 2013 to gather further information and clarification on a short list of questions sent on the same day. The BNetzA statement during the conference call was also confirmed to the EWG by email on 9 July.

A draft opinion was finalised on 24 July 2013 and a final opinion was presented and adopted by a majority of the BEREC Board of Regulators on 1 August 2013. This opinion is now issued by BEREC in accordance with Article 7a (3) of the Framework Directive.

3. BACKGROUND

Previous notifications

The third round of market analyses of the market for call termination on individual public telephone networks provided at a fixed location in Germany was previously notified to and assessed by the Commission under case DE/2012/1359[4]. At the time BNetzA notified its proposal for market definition and the assessment of significant market power (SMP).

BNetzA proposed to define markets for call termination on individual public telephone network at a fixed location including call forwarding. Only services allowing the termination on the lowest interconnection level were covered by the market definition. BNetzA proposed to designate 57 operators as having SMP on their relevant markets.

The Commission had no comments as to the market definition and the SMP assessment with respect to the market for wholesale fixed call termination.

On 6 March 2013, BNetzA notified to the Commission under case DE/2013/1430[5] its draft measures concerning remedies to be imposed on DT. In these draft measures, BNetzA proposes to impose among others the following obligations: interconnection and conveyance obligation, co-location obligation for interconnection purposes and price control obligation. With regards to the obligation of cost-orientation, BNetzA proposes to set (retrospectively, as of 1 December 2012 to 31 December 2014) the following fixed termination rates (FTRs) for DT: 0.36 €c/min (peak) and 0.25 €c/min (off-peak). In BNetzA view, these rates are calculated based on a LRAIC+ cost methodology.

On 8 April 2013, the Commission expressed its serious doubts as to the compatibility of the proposals with EU law concerning the price control remedies for call termination, due to the methodology used to calculate the costs of services.

[4] C(2012) 5904
[5] C(2013) 4011

On 17 May 2013, BEREC issued an opinion[6] considering that the Commission's serious doubts are justified in that BNetzA's proposed FTRs are not based on a pure LRIC costing methodology and no valid justification has been provided for such deviation.

In a parallel process which was also centred on the LRAIC+ versus pure LRIC discussion, the Commission has issued on 27 June 2013 a Recommendation for BNetzA to implement pure LRIC mobile termination rates in Germany no later than 1 October 2013[7].

Current notification

In the current notified draft measure BNetzA proposes to impose on the SMP operators other than DT the following obligations (i) obligations to provide interconnection and termination services, (ii) co-location obligation for interconnection purposes, including the obligation to give colocation users access to facilities at all times, (iii) obligation to ensure that access agreements are based on objective criteria, are transparent, grant equally good access and meet the requirements of fairness and reasonableness, (iv) obligations to publish technical specifications, network characteristics, conditions of provision and the rates for interconnection and termination services, (v) obligation to submit the access agreements to BNetzA, (vi) price control obligations by way of setting symmetrical rates through a benchmarking method based on the proposed FTRs of DT as notified under case DE/2013/1430.

The current notified measure imposed provisional symmetrical rates on the two operators Netzquadrat and T&Q. Except for these two SMP operators, all undertakings have committed to charge in reciprocity the provisional termination rates of DT as of 1 December 2012.

Costing methodology proposed on national benchmarking

With regard to the proposed national benchmarking, the suggested FTRs under the current notification, although being symmetrical, will rely on the same LRAIC+ methodology used for the FTR for DT. This means that non-traffic related costs, such as rental and common costs are being included in the cost model for FTRs on which the final level is based.

BNetzA states in its current notification, as expressed in case DE/2013/1430, that the relevant provisions of the German telecommunications law (TKG) have to be interpreted in the light of EU law in general and the Termination Rates Recommendation in particular, and that – in case of conflict – methods set out by the Commission prevail over the regulatory default model set out by national law.

In similarity to the case DE/2013/1430 which dealt with the FTR imposed on DT which is the benchmark for the proposed FTR for Netzquadrat and T&Q, BNetzA also argued in the present case that its approach is justified by the need to comply with the TKG and to take into account the actual characteristics of the German Telecommunications market.

BNetzA therefore justifies its decision not to follow a core part of the Termination Rates Recommendation by alleging that the LRAIC+ approach will contribute to the development of

[6] BoR (13)55
[7] C(2013) 3954, case DE/2013/1424

the internal market and is better suited to meet the policy objectives provided for in Article 8(1) of the Framework Directive and in Article 8(4) of the Access Directive. Further to this, according to BNetzA, pure BU-LRIC would neither better support the interest of other fixed operators or of citizens and end-users. Finally, BNetzA considers that calculation of fixed rates according to pure BU-LRIC would increase the difference between mobile and fixed termination charges and that the LRAIC+ approach for setting FTRs is better suited to reduce the gap between FTRs and MTRs. Applying pure BU-LRIC would, according to BNetzA, significantly reduce the revenues of fixed operators, thus hampering their investment capacities.

Concerning the proposed costing methodology based on LRAIC+, in similarity to the views expressed by BNetzA in case DE/2013/1430, the same issues remain relevant and include, *inter alia,* the inclusion of non-traffic related costs which could be attributable to services other than wholesale voice fixed call termination, and NGN CAPEX (capital costs) which are set on the basis of a bottom-up modelling approach, while other cost elements such as OPEX, rental costs product/supply costs related to technology and distribution, common costs, as well as specific PSTN costs, are taken from DT's regulatory accounts.

With respect to all the remaining operators already identified with SMP on their respective fixed voice call termination markets, BNetzA plans to notify the corresponding regulatory measures subsequently to the currently engaged process. The current provisional decisions on Netzquadrat and T&Q may be considered as a model for all other alternative network operators.

Commission's serious doubts

The Commission expresses serious doubts regarding the remedies on the market for wholesale voice call termination on individual fixed networks in Germany for the following principal reasons:

> **The need to ensure that customers derive maximum benefits in terms of efficient cost-based termination rates**

Compliance with Articles 8(4) and 13(2) of the Access Directive in conjunction with Article 8 of the Framework Directive and Article 16(4) of the Framework Directive

The Commission observes that BNetzA uses a national benchmarking approach and proposes to set fixed termination rates benchmarked against the rates of DT, that are based on a LRAIC+ methodology which - contrary to Recommends 2 and 6 of the Termination Rates Recommendation - allocates non-traffic related costs to the provision of the fixed termination service.

The Commission underlines that, given the characteristics and the associated competitive and distributional concerns of termination markets[8], the objectives of promoting efficiency and sustainable competition, maximizing consumer benefits and contributing to the

[8] The accompanying Explanatory Note of the Commission Staff Working paper (SEC(2009) 600, 7.5.2009).

development of the internal market would best be achieved by a cost orientation obligation remedy based on a pure BU-LRIC methodology and a narrow definition of the increment.

The Commission does not share BNetzA's view that its proposed method is better suited (than pure BU-LRIC) to serve the policy objectives of promoting competition and protecting EU citizens' interests without proposing sufficient evidence of a departure from pure LRIC costing methodology.

Moreover, the Commission observes that fixed termination rates set at an efficient level contribute to a level playing field among operators by eliminating competitive distortions between fixed and mobile networks in the provision of termination services. Also the Commission reminds that, when deciding on the correct level of the regulated wholesale termination rate, it is essential to ensure that the methodology promotes efficient production and consumption decisions and minimizes artificial transfers and distortions between competitors and consumers.

The Commission recognised that NRAs can deviate from the Termination Rates Recommendation but that an alternative methodology should be duly justified in light of the policy objectives and regulatory principles of the Regulatory Framework.

The Commission observes that although the benchmarked cost model is NGN-based, it allows for the recoupment of some PSTN costs. However the cost model should be based on efficient technologies available in the time frame considered by the model, therefore the core network of a model built today should ideally be NGN-based, to the extent that the costs of such a network can be reliably identified. Given the high proportion of PSTN costs included, in view of the impact on the final results and the prospective replacement of PSTN with IP technology by an efficient operator, the Commission considers that BNetzA could have reduced the share of PSTN related costs on a forward looking basis.

Furthermore, the Commission notes that, although reconciliation exercises can be performed in order to identify the sources of differences, to quantify those differences and to make appropriate adjustments accordingly with a view to assist in the verification of pure BU-LRIC models, BNetzA's approach to reconciliation starts from DT's data. Given the source of the OPEX and the absence of BU-LRIC modelling for OPEX, it is difficult to assess to what extent the proposed adjustments have been sufficient to address DT's potential inefficiencies.

The Commission consequently considers that Articles 8(4) of the Framework Directive and Article 13(2) of the Access Directive have not been adequately followed.

The Commission considers that BNetzA neglects the fact that pure BU-LRIC approach is better suited to facilitate a more efficient distribution of financial transfers between competing operators, thus ultimately minimising the risk of problems such as cross-subsidisation between operators, inefficient pricing and/or investment behaviour.

In particular, the Commission considered that the proposed LRAIC+ methodology may lead to competitive distortions between operators with asymmetric market shares and traffic flows and, ultimately, lead to the application of consumer tariffs, which are based on wholesale inputs above avoidable costs.

Creation of barriers to the internal market

The Commission notes that the application of a LRAIC+ methodology leads to a considerable difference in absolute terms between German FTRs resulting from BNetzA's proposed approach and those of other Member States which employ a pure BU-LRIC methodology in compliance with the Termination Rates Recommendation and in line with Articles 8(4) and 13(2) of the Access Directive.

Any such considerable asymmetries in fixed termination rates within the EU not only distort and restrict competition but have a significant detrimental effect on the development of the internal market, i.e. create a considerable barrier to the single market, and, therefore, result in a violation of the principles and objectives of Article 8(2) and (3) of the Framework Directive.

A harmonised approach in setting fixed termination rates is particularly important to ensure that regulators do not favour their national operators at the expense of operators in other Member States by not introducing fully cost-oriented termination rates.

4. ASSESSMENT OF THE SERIOUS DOUBTS

On 20 June 2013, the Commission sent a serious doubts letter opening a phase II investigation pursuant to Article 7a of Directive 2002/21/EC as amended by Directive 2009/140/EC.
Concerning the proposed application of a national benchmark to set termination rates in Germany against the rates of DT, BEREC reminds, as in case DE/2013/1430, that the legal starting point for its analysis has to be the pure BU-LRIC approach as laid down in the Termination Rates Recommendation and not the LRAIC+ (designated under CESP/KeL, standing for Cost of Efficient Service Provision) approach followed by BNetzA. Starting from the Termination Rates Recommendation would ensure that all arguments developed by the European Commission in favour of a pure BU-LRIC approach are adequately reflected.

BEREC assesses the serious doubts in three parts. The first part deals with the legal aspect of the German telecommunication law vs. the European regulatory framework. Then, BEREC assesses the two main concerns of the Commission, each time taking into account BNetzA's arguments considering whether to justify deviation from the Termination Rates Recommendation. The first concern being *the need to ensure that customers derive maximum benefits in terms of efficient cost based termination rates*. The second concern refers to *the creation of barriers to the internal market.*

4.1. General observations

In its notified draft decision, BNetzA explains that, based on its national law, the non-recognition of common costs falls within its wider discretion to choose the most appropriate regulatory model. This comes from the fact that under Section 30(1) of the TKG, the Deliberation Chamber decided to subject the charges for termination services of the authorisation pursuant to the standard of Section 31 of the TKG.

Within Section 31(1)(1) of the TKG, BNetzA can approve rates on the basis of the CESP (or LRAIC+) according to section 32[9] for the individual services, but has the derogation, within Section 31(2)(2) to approve rates on the basis of other procedures, provided that the procedures according to paragraphs 1 or 2 are better suited than the procedures referred to in subsection (1) (especially referring to section 32) to achieve the regulatory aims according to section 2.

In BNetzA's view, based on the TKG, its role is to assess whether pure LRIC costing methodology ("other procedures") is better suited than LRAIC+ (cost methodology according to Section 32 (1)) to achieve the policy objectives.

Furthermore, BNetzA explains in its notified draft that, based on section 32(2) of the TKG, recognition of costs in addition to CESP/KeL (or LRAIC+) is objectively justified and deriving from a legal obligation, in case of costs related to redundancy payments. BNetzA also explains that while there is no legal obligation to maintain PSTN in Germany, recognition of PSTN costs in FTR is objectively justified by the fact that the switch from PSTN to NGN is a deep lying technical change the implementation of which requires considerable investments.

BEREC considers that under Article 19 of the Framework Directive, an NRA can deviate from a recommendation, here the Termination Rates Recommendation, under the condition that it informs the Commission giving the reasons for its position.

According to Article 13(2) of the Access Directive, an NRA shall ensure that any cost recovery mechanism or pricing methodology that is mandated serves to promote efficiency and sustainable competition and maximise consumer benefits, and it is recommended by the Commission, within Article 2 and 6 of the above Recommendation, that the cost of efficient service provision for fixed termination rates is the pure BU-LRIC. Therefore, under the current EU framework, any NRA which wants to deviate from it has to provide sufficient reasons as to why another cost methodology would be better suited to meet the policy objectives.

As a consequence, in the present case, BEREC cannot endorse BNetzA's approach, i.e. deviating from pure LRIC on the basis of the justification that pure LRIC would not be better suited than LRAIC+ (see section 3.6.5. in particular 3.6.5.1.3 on page 35f. of the notified document[10]), but considers that a proper justification of the choice of LRAIC+ by BNetzA should have consisted in assessing whether LRAIC+ would be better suited than pure LRIC to meet the policy objectives.

Indeed, as BEREC has to assess the serious doubts based on the regulatory framework it cannot take the German law as its starting point of analysis.

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[9] The costs of efficient service provision are derived from the long run incremental costs of providing the service and an appropriate mark-up for volume-neutral common costs, inclusive of a reasonable return on capital employed, as far as these costs are required to provide the service. Section 79 remains unaffected.

[10] In the following, we are referring to the document number BK 3g-12/0XX (non-confidential version of the draft consolidation order, also named as draft regulatory document or remedy draft).

4.2. Assessment on *the need to ensure that customers derive maximum benefits in terms of efficient cost based termination rates*

In order to assess the Commission's serious doubts on *the need to ensure that customers derive maximum benefits in terms of efficient cost based termination rates*, BEREC has divided its analyses into four parts: methodological issues, fixed to fixed competition issues, mobile to fixed competition issues and costing issues.

a. Methodological issues on the LRAIC+ approach chosen

This section concentrates on BNetzA's arguments referring to static efficiency, that is:

- How a competitive outcome would look like?
- Whether such a model would be appropriate taking into account the specifics of the termination service?
- What are possible ways to contribute efficiently to a potential recovery gap?

These issues are not discussed in detail in BNetzA's present draft decisions on fixed termination rates of the two alternative SMP operators, they are nevertheless relevant, as some of the underlying assumptions made by BNetzA seem questionable to BEREC. In addition, some important arguments in favour of pure LRIC – i.e. call externalities and utility distribution – do not seem to be adequately reflected. Overall, the present draft decisions build on several aspects of the previous draft decision taken by BNetzA on termination rates of DT, as the proposed rates follow those FTR to implement symmetry (as recommended by paragraph 1 of the Termination Rates Recommendation) amongst fixed network operators.

Views of BNetzA

After explaining the Commission's pure LRIC approach and the advantages of KeL (LRAIC+ or CESP)[11], BNetzA concludes[12] that: *In the present case, it cannot be proved as a result of general economic considerations or with a view to the special features of the termination market that a competition price for terminations would rather swing towards the LRIC level than to the costs of providing efficient services level. An LRIC-regulation cannot in any case be justified from the viewpoint of emulating the competition price.*

BNetzA's general orientation when setting appropriate prices for the fixed termination service is the simulation of a competitive outcome (the "as-if competition price"), which was the starting point of the discussion on allocative efficiency. In this context BNetzA builds on its experience: *In the previous regulatory practice relating to termination fees, the Deliberation*

[11] This discussion leads BNetzA to the conclusion: *It can neither be established that the recommended LRIC-price corresponds to the competition price better than the cost of providing efficient services-price, nor can it be concluded by way of an impact assessment that an LRIC-price would be better suited than the cost of providing efficient services-price to prevent an undesired capital outflow from other sectors and/or clearly improve the competitive behaviour of fixed network operators or mobile operators in the retail markets.* (sect. 3.6.5.1.3.1). The next sections will discuss the arguments which lead to this conclusion in more detail.

[12] Remedy draft, section 3.6.5.1.3.1.1

Chamber assumed that the price of termination of costs of providing efficient services corresponds to the as-if competition price and setting it prevents competition distortions. This assessment is now questioned by the Termination Rates Recommendation of the Commission[13]. Further in the discussion of the emulation of a competitive price, BNetzA states: *For the present case, the previous considerations imply that the overall amounts for coverage of termination costs should correspond to the unit costs of an efficient network operator, regardless of which customer they are raised from.* Referring to the specifics of the termination service: *Upon presence of two immediate service recipients, an undertaking primarily has the option, like the subject, to require a coverage amount from both sides for the unit costs of the service provided. […] An undertaking will orient itself towards the respective price elasticities in answering whether and how such a distribution is made*[14]. However […] *From the circumstance that unit costs of the termination service could basically be covered from two sides, it cannot be derived that in the case of competition both sides would actually be taken into consideration.[…] The principle is valid that each undertaking, even a market-dominant one, is entitled to entrepreneurial leeway. It is basically left to it to determine the type of its economic activity itself and it to design its purchase and sales system at its own discretion in a way which it considers correct and meaningful, provided that it does not use such means herewith which run counter to the freedom of competition.* [15]

<u>*BEREC's Assessment*</u>

First, BEREC would like to make the following comments on the starting point of BNetzA's analysis – "the emulation of a competitive outcome/as-if competition price". This analysis draws extensively from what has been stated in BEREC's opinion DE/2013/1424 and DE/2013/1430, as from a methodological point of view, most of these aspects apply to mobile and to fixed termination alike:

- Even in highly competitive markets, it is not necessarily the case that a multiproduct firm will allocate joint and common costs with an (equal proportionate or volume proportionate) mark-up to all products offered. So, although it is understood that on the whole, the total (efficient) costs need to be recovered, this does not mean that each product will contribute - or even contribute equally - to achieve this.

- To take an emulated competitive outcome (the "as-if competition price") that also accounts for joint and common costs as starting point, would in BEREC's view only be appropriate if the outcome was an efficient allocation (in terms of no welfare losses, i.e. prices are reflecting marginal utilities). This is not the case with an equal proportionate mark-up as the termination service is a two-way access service and encounters (under a CPP regime) a call externality, which is not taken into account. Not considering this call externality when regulating FTRs, puts in doubt, whether economic efficiency aspects (as well as sustainable competition and the aim to maximise consumer benefits) were adequately reflected. To the extent that this market failure was not addressed, the proposed "as if – competition price" cannot be economically efficient.

[13] Ibid, section 3.6.5.1.3.1
[14] Ibid, section 3.6.5.1.3.1.1.2
[15] Ibid.

- Applying the proposed LRAIC+ (CESP) method to the termination service means that the whole cost of the call would be covered by the calling party, while this calling party is also contributing to the recovery of the networks' joint and common cost of the terminating company. While it is agreed that the distribution of utility for the two parties involved in a call cannot be specified with certainty, the Commission has taken into account this externality when developing the recommended approach. BNetzA does not elaborate on this key argument.

- Concerning BNetzA's view that a LRAIC+ approach is better suited to represent the efficient unit costs (sec. 3.6.5.1.3.1.1.3 remedy draft), as *even the (relevant to wholesale and efficient) cost of co-production, are allocated in an activity-based manner*, one needs to take into account that a recovery gap resulting from a switch from CESP to pure LRIC can only emerge in case of a net-inflow of traffic[16]. Also, from an efficiency point of view, the most appropriate way to recover such a gap would be to let the operator decide on the basis of price elasticities - with the side condition that the common cost recovery should preferably come from markets/services with effective competition or from regulated wholesale services in a way that a negative competitive impact is minimized. Such a recovery would be clearly preferable over a LRAIC+ based recoupment from termination, which does not address the market failure and hence does not aim to minimize the resulting efficiency losses. This was also reflected by BEREC in its opinion on Case NL-2012-1284[17].

- Concerning BNetzA's argument that [with the LRIC+ approach]*… even the (relevant to wholesale and efficient) costs of co-production are allocated in an activity-based manner (…) In this context, it needs to be shown that in the opinion of the Deliberation Chamber, there is no justification to consider services used which are purely internal to the network as main services and services which are sold external to the network as additional services to be considered with the result that overheads should be borne only by the main services* [18] it has to be noted beforehand that costs in a telecom environment are not axiomatic, but are the direct result of the framework for regulatory costing, of accounting principles as well as their application. Secondly, the framework for regulatory costing has at the same time to reflect market circumstances, address their failures and promote efficiency. Therefore reducing the efficiency analysis to a rather specific interpretation of cost causation (i.e. source based according to the question who is triggering the service), is not sufficient as it does not take into account the specific nature of the termination service.

[16] In case of a net-outflow, a lower termination rate would be beneficial for the operator. This is frequently the case with smaller networks and is also noted in Recital 3 of the Termination Rates Recommendation. In case of a net-inflow revenues are cut and must hence be recovered from other services. However, BNetzA's draft remedy document does not differentiate amongst various groups of operators affected.

[17] BEREC opinion on case NL-2012-1284, page 13: There is an objective reason to recover common costs on retail markets rather than on the wholesale termination markets. By taking into account pure incremental costs when determining termination rates operators are being encouraged to recover their common costs on retail markets (on which there is a price constraint) and not on a monopolistic *market (on which there is a risk of excessive prices).*

[18] Remedy draft, section 3.6.5.1.3.1.1.3

Based on this reasoning, BEREC notes that it cannot follow BNetzA's reasoning that LRAIC+ (CESP) would be a more appropriate costing methodology than pure LRIC to calculate efficient termination prices.

b. Fixed to fixed competition and consumer interests issues

Views of BNetzA

BNetzA argues[19] that pure LRIC is not better suited than LRAIC+ to control the competitive behaviour of fixed networks and that as under the current CESP (LRAIC+) regime for FTRs, the retail fixed telephony in Germany is already characterised by the extensive presence of flat-rate (lump-sum) offers. Therefore a pure LRIC measure would not essentially reinforce this development and would not lead to further reducing retail prices, which in BNetzA's view are already low.

BNetzA further states[20] that under a pure LRIC approach, the costs which can no longer be recovered from competitors would need to be recovered from the fixed operators' own customers, so that overall, fixed network customers would be negatively affected. In addition BNetzA considers it cannot predict to what extent customers of smaller alternative networks, or certain categories of customers (business, private, low usage) would be affected following the setting of FTR at pure LRIC levels.

On the other hand BNetzA notes that it cannot reliably estimate the impact of pure LRIC (as opposed to LRAIC+) on the structure of prices or on the volumes of services. According to BNetzA, presently on-net/off-net tariff differentiation is no longer observed in the German market and the flat rates which characterise even the basic offers in the fixed telephony are no longer dependant on the introduction of pure LRIC. However, BNetzA considers that *The reduction of termination fees and other connection fees to be expected also by apply costs of providing efficient services-regulation (…) is therefore passed on in the form of cheaper package prices*[21]. BNetzA then concludes that reaching lower retail prices through lower wholesale tariffs and subsequently higher usage cannot be fostered any more through a pure LRIC regulation.

The Commission's Concerns

The Commission in its serious doubt letter states that it *does not agree with BNetzA's assertion that the difference between LRAIC+ based FTRs and pure BU-LRIC based FTRs would lead to an increase of regulated operator's prices for end-users. The Commission considers that BNetzA's argument of a waterbed effect represents a static viewpoint. While cuts in the termination rates may imply price restructuring at retail level, this does not necessarily translate into higher retail tariffs since FTR cuts also lead to dynamic effects which should also be considered. In particular, aligning all termination fees at an efficient cost level gives incentives to operators to compete for subscribers, e.g. by launching new retail packages thus providing additional revenue opportunities for the fixed operators and*

[19] Remedy draft, section 3.6.5.1.3.1.2.2
[20] Ibid., section 3.6.5.1.3.2
[21] Ibid.

ultimately greater product/service choice for its end-users. Therefore, the Commission does not share BNetzA's view that its proposed method is better suited (than BU-LRIC) to serve the policy objectives of promoting competition and protecting EU citizens' interest.

BEREC's Assessment

First of all, BEREC understands that while the current draft measure concerns only the FTRs to be applied by the two alternative SMP operators, BNetzA considers the application of symmetrical termination rates with respect to all providers, at the level of DT's local termination rate (excluding transit charge elements).

Building on BNetzA's arguments that on-net/off-net tariff differentiation is not practiced any more in the fixed market, as fixed telephony is frequently offered at lump-sums (flat rates), BEREC has attempted to gather information on the magnitude of the network effect in the fixed networks[22], but there was no information available.

BNetzA failed to support evidence about the lack of influence of pure LRIC on flat rate competition (compared to current LRAIC+ situation). On the contrary, to the extent that fixed telephony is offered at a lump-sum (flat-rate), whether a reduced FTR would be translated into a more competitive lump-sum price for fixed telephony or for the entire bundle will depend on the fixed markets' competitive dynamics. For example in the presence of lump-sums, a reduced FTR could lead to i) more minutes included in the lump-sum (e.g. for those bundles that are not unlimited); ii) more "unlimited calls" bundles; and/or iii) more competitive prices for "unlimited bundles".

Secondly, lack of on-net/off-net price differentiation in the German fixed telephony market does not mean that in the presence of traffic imbalance to the detriment of smaller or new entrant operators, a reduction in fixed termination rate does not improve a potential net financial deficit e.g. vis-à-vis larger ones. This improvement means that, contrary to BNetzA claims, in the presence of lower FTRs it will be easier for smaller and new entrant operators to cover non-incremental costs, which, importantly for the competitive process, would in turn enhance their capacity to compete despite smaller economies of scale.

BEREC therefore considers that the presence of flat rate or bundled fixed telephony does not in itself mean that competition and consumers can no longer benefit from FTR reductions, or that flat rates *per se* can justify conservative approaches to the regulatory costing of fixed termination.

Thirdly, it is not clear to BEREC why, in BNetzA's view, past reductions in FTRs have been translated into more competitive retail pricing, while a further reduction would reinforce this phenomenon only to the extent it is not purely LRIC-based. In this respect, BEREC has attempted to gather information regarding the potential impact of a pure LRIC relative to a LRAIC+ FTR on the various fixed operators in Germany (integrated fixed-mobile operators, resellers, etc.), as well as on a potential "waterbed" effect on the German consumers (business, low usage, etc.), but there was no information available.

[22] on-net versus off-net fixed volumes.

In BEREC's view, whether and to what extent the impact on German operators (of implementing pure BU-LRIC FTRs) is passed on to the retail market would primarily depend on a number of factors related to the competitive conditions in the German fixed voice retail markets, as well as on the magnitude and the distribution of impacts[23]. For instance, leaving aside for a moment dynamic benefits on competition and consumers, if the direct net impact of implementing pure LRIC is positive for a number of operators, it can act as a constraint on other operators to raise prices to consumers.

While the potential for and magnitude of a hypothetical waterbed effect should in principle have been thoroughly investigated when assessing the choice over the relevant increment for FTRs, BEREC notes that not only BNetzA did not analyse the impact of implementing pure BU-LRIC FTRs on fixed operators or on the retail prices in fixed networks, but also that no evidence has been provided neither on the potential existence of a waterbed effect, nor on its potential magnitude. Moreover, considering that i) different fixed operators would likely be impacted differently by the implementation of pure BU-LRIC FTR; ii) some fixed operators would likely be positively impacted; and iii) BEREC's understanding of the intensity of competition in the German retail market, an eventual waterbed effect is likely to be of trivial magnitude if not improbable.

BEREC also agrees with the European Commission that the application of a pure BU-LRIC model will contribute to increased welfare gains to the consumers, which is of paramount importance bearing in mind the content of Articles 8(4) and 13(2) of the Access Directive and Article 8 of the Framework Directive. These gains will be due, on one hand, to increased levels of allocative (static) efficiency in the overall market, which will tend to be passed on to consumers in competitive markets, and, on the other hand, to increased levels of competition in the market. This effect, in the understanding of BEREC, will prevail over an improbable "waterbed effect". The risk that BNetzA mentions – namely that it is unforeseen which classes of consumers would bear the costs of a potential "recovery gap" – is, in the opinion of BEREC, lower than the risk of applying a cost model which fails to address the market failures present in the market. BEREC also considers that the lowering of termination rates can provide smaller operators an improved ability to match and/or offer more innovative retail offers.

For the reasons stated above, BEREC agrees with the European Commission that no theoretical and/or empirical arguments have been put forward by BNetzA that could allow concluding that an LRAIC+ methodology would be better suited than a pure LRIC one, in regards competition between fixed operators and the maximisation of consumer interests.

c. Mobile to fixed competition and circularity issues

Views of BNetzA

BNetzA notes[24] that, in contradiction with the Termination Rate Recommendation, pure LRIC cannot better address the issues of capital outflow from fixed to mobile networks or the desired competition results in the form of competitive and possible lump-sum retail tariffs, as compared with LRAIC+ (CESP/KeL). BNetzA further argues[25] that a pure LRIC regulation of

[23] see for example BEREC opinion on case IT/2013/1415
[24] Remedy draft, section 3.6.5.1.3.1.2
[25] Ibid, section 3.6.5.1.3.1.2.1.1.

FTR cannot counteract capital outflows into the mobile sector, since MTRs will be LRAIC+ based and under such circumstance the absolute asymmetry between FTRs and MTRs will increase, which in turn would be contrary to the aim of recital 3 in the Termination Rate Recommendation.

The Commission's Concerns

The Commission notes that: *In addition, BNetzA argues that the use of BU-LRIC for FTRs (instead of LRAIC+) would decrease the level of FTRs thus increasing the FTR-MTR price difference. Moreover, setting FTRs on the basis of BU-LRIC would according to BNetzA reduce the revenues of fixed operators and hamper the investment capacity of the fixed sector. The Commission is of the view that BNetzA's reasoning does not take into consideration the downward impact of BU-LRIC on MTRs, which would lead to a reduction of payments from fixed to mobile operators, in particular when applying the recommended approach also for MTRs. When notifying the cost model for fixed termination rates of DT, BNetzA did not analyse net payments effects based on traffic flows nor did it calculate what the level of BU-LRIC based FTRs would be. Against this background, the Commission considers BNetzA's comparative approach BULRIC/ LRAIC+ as limited.*

BEREC's Assessment

With respect to the main arguments, BNetzA's analysis goes along the same lines as the one presented in case DE/2013/1430. At that occassion BEREC noted in its opinion, that further empirical evidence and a more detailed analysis would have been necessary to confirm the argumentation provided by BNetzA. Despite BEREC's expectations, the current notification perpetuates the same line of argumentation without any supplementary analysis.

In BEREC's view, there is a circularity in BNetzA's statement, when it argues that the LRAIC+ based MTRs are (amongst other reasons) a barrier to setting FTRs at pure LRIC (or BU-LRIC in the Commission's terms) rate, as otherwise this would result in even increased capital outflows from fixed operators, which in turn would be against the Commission's Termination Rates Recommendation. BEREC notes, that - in its opinions on cases DE/2013/1424 and DE/2013/1430 - it agreed with the Commission's view, that BNetzA did not provide sufficient evidence that a deviation from the Termination Rate Recommendation would have been justified in case of MTRs and respectively in case of DT's FTRs. Therefore, BEREC shares the Commission's (implicit) view, that an argumentation which refers to LRAIC+ MTR's is entirely unjustified. BEREC accepts in principle that, in a situation with LRAIC+ based MTRs and pure LRIC based FTRs, the competitive distortions between fixed and mobile networks might be further accentuated. However, this issue is of no relevance in itself, as there is in fact no justification to treat mobile and fixed termination rates conceptually differently.

However, in BEREC's view, there are some analytical elements missing in BNetzA's argumentation of the fixed-mobile relation. Firstly, and in support with what the Commission raised in its serious doubts letter, BEREC would have expected that BNetzA had done an analysis on a pure LRIC approach covering both fixed and mobile termination rates. Absence of detailed cost calculations does not make it less evident that the absolute level of fixed-mobile termination rate differential will be lower under pure LRIC than under LRAIC+.

Recent decisions of NRAs applying pure LRIC have already clearly indicated that the application of pure LRIC to FTRs and MTRs leads to lower absolute differentials between these two regulated services. Hence – depending on the traffic flows between the networks – the fixed network operators (and in the end their customers) would be better off under pure LRIC. It has already been mentioned under 4.2.b. above that pure LRIC FTRs could facilitate start-up or smaller fixed network operators and thus have a positive impact on the dynamics of competition. But the argument goes further: when fixed network operators are confronted with a higher fixed-mobile termination rate difference because of pure LRIC based FTR (and LRAIC+ based MTRs), it is economically rational for the fixed operators, as many of them did, to argue in favour of LRAIC+ FTRs.

Furthermore, the use of LRAIC+ (as opposed to pure LRIC) to set termination rates distorts the level playing field between fixed and mobile operators. A larger cost base included in the regulated fixed termination rates means that fixed operators are allowed to recover from regulated termination a significantly higher cost base, at the expense of mobile operators and ultimately mobile consumers as well as from mobile/fixed consumers abroad. Such an approach also risks underestimating the competitiveness of fixed networks.

Lastly, given the traffic imbalances between fixed and mobile networks, the comparatively smaller net flows of revenues from fixed operators to mobile operators implied by the use of pure LRIC (instead of LRAIC+), as well as the level playing field introduced by pure LRIC in the regulatory treatment of termination services and the stronger retail competition, BEREC does not see how a pure LRIC approach to FTRs would not, in combination with pure LRIC MTRs, provide more incentives for NGN/NGA investments from the part of fixed operators.

For these reasons above, BEREC also agrees with the European Commission that BNetzA did not provide sufficient evidence that would allow concluding that an LRAIC+ would be better suited than a pure LRIC, with regards to competition between fixed and mobile operators and the interests of consumers.

d. Costing PSTN and OPEX issues

BNetzA's views

BNetzA's views on these issues are set out in the Draft Decisions of the Third Deliberation Chamber[26] in which it argued that adding PSTN expenses is justified by Section 32 (2) of the TKG, the *important objective* [of which] *is to allow the regulated undertaking to refinance expenditure which may not be a part of the costs of efficient service provisions but are still necessary due to legal requirements or other material reasons*. BNetzA said that a deviation from the regulatory benchmark is deemed acceptable to the extent that it prevents a cost recovery shortfall which cannot be attributed to the undertaking not being sufficiently efficient.

BNetzA considered that, while DT is not legally obliged to maintain its PSTN network, accounting for the costs of PSTN is materially justified on the basis that the switch from PSTN to NGN is a deep-lying technical change and that unlocking the efficiency gains of NGN requires considerable investment in other products with no indication that DT has not

[26] Documents BK 3d-12/009 and BK 3c-12/089.

implemented these changes. In addition, BNetzA considered that the development in the competitors' networks also showed evidence that the PSTN technology still meets the principle of path-dependent efficiency, since the number of PSTN connections has only been reduced slightly since 2008. BNetzA also took into account the PSTN expenses on the basis of real payments made by DT, not cost accounting methods; in particular, it considered these expenses were to be determined based on the costs of procurement and production and not on the alternative basis of replacement values.

The Commission's concerns

The Commission observed that BNetzA proposes to set fixed termination rates benchmarked against the rates of DT that are based on a costing methodology which does not appear to comply with the principles and objectives set out in the regulatory framework and, in particular, the importance of ensuring that the methodology chosen pursuant to Article 13(2) of the Access Directive promotes efficient production and consumption decisions and minimises artificial transfers and distortions between competitors and consumers.

The Commission reiterated its view that the core network of a model built today should ideally be NGN-based (to the extent that its costs can be reliably identified) but considered that a hybrid PSTN/NGN model might be compliant with the Recommendation provided that the resulting costs are traffic-related and in line with pure BU-LRIC modelling principles. It is further noted that, although the benchmarked cost model is NGN-based with recoupment of some PSTN costs, the model included common and other non-traffic related costs elements. The Commission considered that BNetzA's methodology should have taken into account on a forward-looking basis the transition to NGN, given the impact of PSTN costs in the proposed FTR.

The Commission also observed that BNetzA derived OPEX from DT's data, adjusted for efficiency and considered that such top-down approach should only have been used to reconcile a potential BU approach which the Commission prefers. It stated that, in absence of the latter, it is difficult to assess to what extent the adjustments are appropriate.

BEREC's assessment

BEREC considers that the key issue in the present case is the fact that BNetzA has not provided a valid justification for deviating from the Termination Rate Recommendation. Specifically, BNetzA has not provided any valid evidence in relation to i) the impact of implementing pure BU-LRIC FTRs in Germany; ii) why such impacts whould justify deviating from the Termination Rate Recommendation; and iii) how the current proposals would address the issues that justified the deviation. BEREC does not consider the specific aspects related to PSTN and OPEX issues of the costing methodology to be the key issue in the present case, but feels compelled to address the serious doubts which the Commission has raised on them.

BEREC does not consider that, in relation to the technological choice, BNetzA's cost model (a hybrid PSTN/NGN) deviates from the Termination Rates Recomendation. However, BEREC agrees with the Commission that a hybrid PSTN/NGN model is suitable *only to the extent that it is based on pure BU-LRIC models for both technologies,* unless a valid justification has been provided to deviate from this model. As discussed above, BEREC considers that such justification has not been provided by BnetzA (see points i), ii), and iii) above).

BEREC also shares the Commission's view that NGN operating costs should be determined using a BU methodology and considers that such costs can now be reliably identified and have already been modelled using a BU-LRIC model by a number of NRAs. Notwithstanding BNetzA's view that its approach "is similar in detail to a bottom-up approach", BEREC shares the Commission's view that, in the absence of a BU determination, it is difficult to assess to what extent the efficiency adjustments are appropriate.

Finally, BEREC shares the Commission's view that BNetzA should have taken into account on a forward-looking basis the transition to NGN.[27] BEREC considers that a weighted average (forward-looking, incremental) cost of the available efficient technologies (e.g., based on the relative amount of traffic expected to terminate on both type of networks) would lead to less inefficient FTRs and would also address the issue of the transition to NGN.

4.3. Assessment on *creation of barriers to the internal market*

BNetzA's views

BNetzA argues[28] that a pure LRIC regulation would not be better suitable to foster the development of the internal market, because such regulation, in the German regulator's view, would not be better capable of meeting the regulatory objectives inscribed in Article 8 of the Framework Directive, particularly those related to competition and consumer protection, than a LRAIC + approach.

The Commission's concerns

The European Commission argues, in its serious doubts letter, that the application of a LRAIC+ methodology in Germany would lead to considerable differences in absolute terms between German FTRs and those of other Member States which are calculated in accordance with the Termination Rate Recommendation. This difference, the Commission goes on to argue, would be incurred at the expense of the operators, and eventually consumers, in the Member States from where the calls originate.

BEREC's Assessment

BEREC shares the Commission's general concern with the impact of widely different termination rates across EU Member States in the promotion of the internal market, and

[27] BEREC could actually not exclude from the information available to it that BNetzA's current methodology involves double counting (at least at some point during the period covered by the review), and therefore could not exclude that such methodology would in any case lead to FTR 'inefficiency'. This potential double counting might explain why the added PSTN costs, which are made of CAPEX and OPEX (rental and operating expenses), amount to a significant proportion of the proposed FTR (**[redacted]**).

[28] Remedy draft, section 3.6.5.1.3.1

notes that this was one of the main reasons why the Commission adopted a Recommendation on termination rates.

However, BEREC also notes, as it has been consistently stated in past phase II opinions[29], that it is not the variation of (mobile and fixed) termination rates within the EU, *per se*, that creates barriers to the internal market, but the unjustified national deviation from a common methodology put forward by the Termination Rate Recommendation. The cost model prescribed in this Recommendation accommodates national specificities, as it aims at calculating the incremental cost of an efficient operator providing services in a particular member state. For this reason, the application of this methodology could in any case result in different termination rates being enforced within the EU. Therefore, absolute levels of termination rates across EU Member States should not be a concern regarding the creation of barriers to the internal market, when the same tariff is charged to national and cross border operators, provided that the recommended methodology is used.

The analysis conducted in the previous sections has shown that, in BEREC's view, BNetzA's decision to deviate from the Termination Rate Recommendation is not justified. Therefore, BNetzA's decision to deviate from a common, Europe-wide methodology would result in a barrier to the internal market, putting the operators and ultimately the consumers in other Member States that apply a pure LRIC methodology at an undue disadvantage. It is of note that, according to BNetzA's response to the questions asked by the EWG in case DE/2013/1430, in 2012 around 13.7 billion minutes originated abroad would have been terminated by German fixed networks. This is a significant figure and its order of magnitude is of around 42% of the overall mobile-fixed traffic in Germany. The peak rate proposed by BNetzA to apply from December 2012 to December 2014 is higher than in any country that has applied a pure LRIC methodology, and stands 230% higher than the average of such countries[30]. The off-peak rate stands at around 129% higher than the average. Although BNetzA says that international traffic is likely to be balanced overall, this may not be the case in relation to specific operators in some Member States, which may suffer a net loss resulting from the application of a benchmark/LRAIC + methodology in Germany.

In light of the aforementioned, BEREC is of the opinion that the approach proposed by BNetzA may create a barrier to the internal market, and therefore shares the Commission serious doubts.

[29] For instance, cases CZ/2012/1392, IT/2013/1415 and DE/2013/1424

[30] All countries in the Benchmark (DK, FR, IE, MT, BG), except Denmark, have a unique rate regarding peak and off-peak periods. Danish rate distinguishes peak and off-peak periods and has a call set up. For the purpose of this text, the Danish rate corresponds to the average rate per minute for a call that lasts 3 minutes, and if 50% of the traffic would be peak/off-peak.

5. CONCLUSIONS

On the basis of the analysis set out in section 4 above, BEREC considers that the Commission's serious doubts are justified in that (i) the proposed approach to set fixed termination rates benchmarked against the rates of DT, that are not based on a pure BU-LRIC costing methodology, as recommended by the Commission based on the economic analysis that shows that pure BU-LRIC results in a better competitive outcome, and (ii) BNetzA has not provided valid justifications for deviating from the Termination Rate Recommendation. In particular, BNetzA has neither proved that the potential impacts of applying pure BU-LRIC based tariffs on German operators and/or consumers would justify a departure from pure BU-LRIC, nor has it proved that its proposal would be better suited to meet the policy objectives of promoting efficiency and sustainable competition and maximize consumer benefits than the pure LRIC. BNetzA therefore did not prove that national circumstances justify the deviation from the recommended FTR costing methodology.

In addition, BEREC shares the Commission's concerns that BNetzA's proposal could create barriers to the internal market if other NRAs set FTRs based on the methodology recommended by the Commission while BNetzA deviates from that methodology without valid justification.

In the light of the Commission's serious doubts and the argumentation above, BEREC recommends BNetzA to set the fixed termination tariffs for Telekom Deutschland GmbH and therefore symmetrical rates through national benchmarking to all other alternative network operator at the level of pure BU-LRIC costs.