

BEREC Guidance on the regulatory accounting approach to the economic replicability test (i.e. ex-ante/sector specific margin squeeze tests)

- Purpose of the Guidance document
- Structure of the Guidance document
- Main findings and conclusions
- Next steps and further timing

Purpose of the Guidance document (1)

- The Guidance document is analysing the economic replicability test (ERT) included as an ex-ante (sector specific) margin squeeze test to safeguard competition in the “Recommendation on consistent non-discrimination obligations and costing methodologies to promote competition and enhance the broadband investment environment 2013/466/EU” (The Recommendation) from a regulatory accounting perspective.
- It looks in particular at Recommend 56 and Annex II of the Recommendation.
- As the Recommendation it focuses on ex-ante margin squeeze tests conducted in Market 4 and Market 5 of the Recommendation on relevant markets susceptible to ex-ante regulation 2007/879/EC.

Purpose of the Guidance document (2)

- Acc. to the Recommendation 2014/466/EU the ERT is the element to safeguard competition in case of non-imposition of regulated wholesale access prices. The ERT should be used in combination with EoI and technical replicability.
- The purpose of the Guidance document is to set out the **possible methodologies** for NRAs to run the economic replicability test in accordance with current practice with ex-ante/sector specific margin squeeze tests.
- The Guidance document aims **to compare the similarities and differences** between the ERT and ex-ante margin squeeze tests and therefore describes the common methodologies already used by NRAs in practice.
- The Guidance document is taking into consideration all existing documents of the Commission, BEREC, ERG and also contains a chapter on margin squeeze tests in competition law practice (including ECJ jurisdiction).

Structure of the document

1. Introduction
2. Parameters of the ex-ante economic replicability test as applied by the Commission Recommendation on consistent ND and costing methodologies (Annex II)
3. Basic methodological choices of the ex-ante margin squeeze mechanics currently applied by NRAs (current practice)
4. Economic rationale and implementation of the ex-ante economic replicability test of the Recommendation in practice
5. Procedural and transparency issues
6. Margin squeeze in the context of competition law, differences with the ex-ante approach
7. Conclusions

Main findings and conclusions (1)

Primary objective

The primary objective of the ex-ante economic replicability test is to safeguard competition in cases where no other cost-oriented price regulation pursuant to Art. 13 Directive 2002/19/EC is imposed. Moreover, the ERT is used to ensure non-discrimination and transparency, preventing exclusion from the market.

Definition of the test

The ex-ante economic replicability assesses whether the SMP operator's retail price (RP_{smp}) of the 'flagship product(s)' or the products considered relevant by the NRA covers the regulated wholesale costs (WC_{reg}), non-regulated input costs (incl. own network costs; $WC_{non-reg}$) and retail costs (LRIC+; RC).

Formula:

$$RP_{smp} \geq WC_{reg} + WC_{non-reg} + RC.$$

Main findings and conclusions (2)

Level of efficiency of the operator

The majority of NRAs use the REO/adjusted EEO test as the preferential level of efficiency while the Recommendation starts with the EEO test, but allows scale adjustments if the SMP operator has frustrated market entry or where very low volumes of lines and their significantly limited geographic reach as compared to the SMP operator's NGA network indicate that objective economic conditions do not favour the acquisition of scale by alternative operators.

Main findings and conclusions (3)

Relevant cost standard

Categories of costs as mostly used by NRAs:

- Regulated wholesale costs: LRIC+
- Non-regulated input costs: LRIC+
- Retail costs: FAC (extracted from SMP operators accounts and adjusted in case of REO/adjusted EEO)

NRAs must ensure consistency when using a combination of cost standards.

Depreciation method

Any relevant depreciation method such as economic depreciation, straight line depreciation, tilted annuity, and other depreciation methods are applicable. Straight line depreciation is chosen by most NRAs for practical reasons.

Reasonable profit

Economic replicability should support efficient build or buy signals, so the investments from alternative operators should be stimulated when efficient. There should be a non-negative margin of the retail price of the product offered by the SMP operator and the sum of the costs necessary to provide the downstream service, so an efficient operator would be allowed to earn a reasonable rate of return.

WACC is clearly the preferred option of NRAs to calculate the reasonable profit.

Main findings and conclusions (4)

Retail costs

Relevant cost categories (marketing, customer acquisition, billing, customer care, bad debt, CPE/distribution of CPE, product development/management) with a reasonable mark-up for common costs added.

Cost categories depend on the tested retail product.

Average user: the relation between wholesale/retail traffic/pricing

The relation between wholesale and retail traffic and pricing could be based on either call minutes/download data included in the retail product or an average end-user consumption profile.

Time Period

Depending on the type of investment costs to be depreciated:

- Customer related investments (e.g. marketing, connection, customer retention): to spread the cost evenly over the expected average customer lifetime;
- Non-customer related investments (e.g. physical equipment): the useful economic life of the asset.

Main findings and conclusions (5)

Regulated wholesale costs

Wholesale prices from the SMP operator's reference offers under a LRIC(+) cost standard approach (imputation).

In cases where there is only an access obligation NRA should consider the access price that the SMP operator effectively charges third-party access seekers for the relevant regulated wholesale input with volume based discounts taken into account.

Non-regulated input costs (incl. own network costs)

- If available: the information on the network costs of the alternative operator
- Or: SMP operator's costs to assess the non-regulated input costs (LRIC+)
- Alternatively the prices commercially agreed on the carrier market could be used.

Main findings and conclusions (6)

Relevant wholesale products

According to the Recommendation the ERT should focus on the most relevant regulated inputs used or expected to be used by access seekers at the NGA –based wholesale layer. Such an input may consist of an active input, a passive input or a non-physical or virtual input offering equivalent functionalities to a passive input. The inputs used may be reviewed over time as the mix of legacy and NGA access products may change over time.

In case relevant wholesale inputs vary according to geographic areas, NRAs should examine the replicability of the relevant retail offer by taking into account the wholesale inputs used in the specific geographic areas (urban/densely populated areas and rural) bearing in mind the objectives to ensure competition and promoting NGA investments when performing the test.

Most of the NRAs include a broader set of wholesale products to the current margin squeeze test (as it is used as a complementary tool).

Relevant retail products

Flagship products

According to the Recommendation the ERT should focus on so-called „flagship products“.

Flagship products might be defined as the product that generates the highest revenue share or the one with the highest market share.

Other criteria to select the flagship products might be possible e.g. advertising costs as suggested by the Recommendation.

Most of the NRAs consider it appropriate to submit a wider set of retail products to the current margin squeeze test (as it is used as a complementary tool).

Main findings and conclusions (7)

Relevant retail products

Level of aggregation of products

To be decided by the individual NRA on the basis of the assessment of competition problems identified in the market analysis.

The Guidance document considers that the use of a product-by-product approach ensures that each bundle/standalone offer is replicable and that there can be no form of cross-subsidy between bundles/standalone offers. The Guidance document admits that from an economic perspective efficiency gains may be better covered by an aggregated assessment approach.

Bundles

Bundles need to be considered in the margin squeeze analysis, especially when they constitute “flagship products”. The definition of bundles is not limited to those bundles which are composed only of regulated elements. From BEREC point of view, if bundled products are relevant in the market, they need to be included in the analysis.

The NRAs would determine the way these components are taken into account according to national circumstances.

Main findings and conclusions (8)

Relevant retail products

Revenues / retail price

In order to determine if there is a margin squeeze between the upstream and downstream level that all downstream revenues and attributable revenues to the bundle/standalone service should be considered in the assessment.

In this regard it is important to take into account level of aggregation and treatment of standalone and bundled products.

Promotions and temporary discounts

As promotions and temporary discounts can be an important element to determine the actual retail costs they should be taken into account. As they can take very different forms in the different markets, NRAs should have flexibility how to take them into account in the margin squeeze test.

The NRAs should check whether “the SMP operator offers at the wholesale level to its own retail arm are the same than those offered to third parties and if these conditions do not threat competition in the retail market”, thus ensuring a level playing field.

A possible measure could be ex-ante communication obligation which entails that operators have to communicate in advance to the NRA the commercial tariffs and discounts, that they are about to launch to the consumers in order to ensure the sufficiency, including economic conditions, of wholesale obligations.

Main findings and conclusions (9)

Procedural and transparency issues

The transparent procedure in place for conducting an economic replicability test, included in the market analysis decision, NRAs should have a certain degree of flexibility when designing their procedure.

Imposing an obligation on the SMP operator to communicate to the NRA the launch of his retail offers is relevant in the context of the procedure of the ERT as foreseen by the Recommendation, given that the latter one considers the launch of new offers as the trigger event for starting the procedure.

Article 10 of the Authorisation Directive empowers the NRA to ask operators to provide additional information or up-to-date information on costs and volumes.

In case the result of the ERT is not compliant with economic replicability obligations, the squeeze must be eliminated. BEREC considers that the NRA should request the SMP operator to amend the wholesale and/or the retail price or to withdraw the retail offer. In accordance with Article 10 of the Authorisation Directive, the NRA can apply proportionate measures (i.e. request price changes or withdrawal of the offer), including financial penalties to ensure compliance with economic replicability obligations.

It is also possible that the SMP operator amends or withdraws the offer on its own initiative.

Competition law margin squeeze test and difference to the ex-ante approach

- The ERT is without prejudice to a margin squeeze test according to competition law (usually applied ex-post)
- Thus as established by ECJ jurisdiction, the ERT cannot prevent that an SMP operator's pricing behaviour may also be subjected to a competition law margin squeeze test ex post.

Next steps and further timing

Task	Date
Plenary 3: Discussed and approved for public consultation at Plenary 3	26th September 2014
Public consultation	29th September - 24th October 2014
Presentation at the Stakeholder Forum	16th October 2014
CN 4: Discussion and approval to pass on to Plenary for adoption	13/14th November 2014
Plenary 4: Discussion and adoption of the final document and publication	4/5th December 2014