

Applying the Economic Replicability Test to fulfill the Recommendation objectives

Presentation by Marc Lebourges
European and Economic Regulatory Affairs - Orange

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Scope of presentation

- Economic rather than legal or regulatory
 - How to fulfil the objectives of the Recommendation with an ERT
 - Economic analysis relevant outside pure application of Reco's ERT
 - In presence of cost-oriented prices, ex-ante margin squeeze not required by the Recommendation
- NGA-specific rather than comprehensive
 - Issues common between NGA and standard BB MST not addressed in detail:
 - Efficiency standard, scope of retail products, choices of wholesale inputs,
...

Objectives to be fulfilled by the test

- Guarantee an “appropriate balance between ensuring efficient entry and sufficient incentive to invest”.
- Guarantee a “degree of pricing flexibility” for NGA investors.
- “Share some of the investment risk by differentiating wholesale access prices according to the access seekers’ level of commitment”.
- “Ensure that the SMP operator is not put at a disadvantage vis-à-vis access seekers regarding sharing of the investment risk” (Annex II).

NGA Investment

- Substitute copper by fibre infrastructure: partly (FTTN/C), more (FTTB), fully (FTTH)
- Under various degrees of platform competition (copper, cable, LTE, ...)
- The higher the proportion of copper infrastructure substituted by fibre, the larger investment risk
- Pay back period from around one to several decades depending in particular on the degree of substitution of copper by fibre:
 - Short term DCF certainly negative, long run DCF uncertain

« Legal certainty is particularly important given that investment in fast broadband networks incurs significant costs, while demand for end products remains uncertain. »

EC Communication to European Parliament (2013), page 7

Economics of NGA investor

Revenue – Cost (Global NGA activity)

=

Revenue – Cost (Wholesale activity)

+

Retail market share

x

Revenue – Cost (Retail activity)

- ERT = Revenue – Cost (Retail activity)
- Calculated on a customer lifetime (< infrastructure lifetime) taking into account all costs including infrastructure sunk costs:
 - Global NGA activity clearly is negative
 - ERT is positive => wholesale activity very negative

Margin squeeze standard for ER test ≠ Objectives of EC Recommendation

- If access price is adjusted to pass the test, transferring all the investment risk to the upstream wholesale business:
 - Guaranteed profitability for NGA access seekers
 - Guaranteed deficit of upstream NGA investors
- Upstream investments economically irrational for investors
- Traditional ER test inconsistent with the EC's assigned objective of sharing investment risks between SMP operator and access seekers.
- LRIC+ cost standard including infrastructure costs would be incompatible with calculation over customer lifetime

Two approaches to solve contradiction between including infrastructure cost and calculating on a consumer lifetime

- **Option 1:**

- From consumer lifetime to infrastructure lifetime

- **Option 2:**

- Consumer lifetime but limiting LRIC+ standard to downstream costs

Option 1: infrastructure lifetime

- DCF calculated on the infrastructure lifetime, with possible option:
 - downstream cost discounted on customer lifetime + upstream cost discounted on infrastructure lifetime
- Economically consistent
- Long infrastructure lifetimes increase regulatory discretion
- Application e.g. if
 - Not too long payback period => more relevant for FTTN than for FTTH
 - Not too risky: significant level of control of the global migration process by the investor

Option 2: customer lifetime but modified cost base

- LRIC+ cost standard only for downstream costs
 - Wholesale input costs not (or not fully, s. below) calculated at LRIC+
- Risk sharing / non linear upstream wholesale prices
 - Supported by 2009 revised framework, NGA recommendation, ND and costing recommendations
 - From lightly non linear (volume / duration discounts) for FFTN to more heavily non linear (upfront payment / cofinancing) for FTTH
 - Modelled as a fixed part + a variable supplementary price per access
 - ➔ Only variable wholesale price per access is incremental in a customer lifetime
 - ➔ Only the variable wholesale price included in ERT

Is ERT with LRIC+ downstream cost + variable wholesale price OK?

- Yes in the sense that once access to NGA is provided, fair competition on NGA can develop
 - Each party taking over relative part of the risk is in line with EC Recommendation: allows fair allocation of investment risk
- But how to avoid foreclosure strategy preventing access to NGA via excessive “fixed” wholesale part?
 - Option 2a: regulatory oversight over fixed and variable parts of wholesale prices
 - Option 2b: add a competition migration test

2.a. Regulate non linear wholesale price?

- Direct regulatory oversight over the share of fixed vs. variable wholesale prices paid by the access seeker
 - Optimal non linear prices critically dependent on individual market situation
 - Requires in-depth assessment of wholesale price
- Not fully aligned with the “no wholesale price regulation” philosophy of the Recommendation

2.b. Add a “Competition migration test” (proposed in Jaunaux – Lebourges EUI paper)

- Competition migration test:
 - $\text{NGA Retail Price} \geq \text{Copper (wholesale price + Downstream cost)} + \text{NGA premium}$
- Can the NGA premium be estimated in practice? If not, the competition migration test may become
 - $\text{NGA Retail Price} \geq \text{Copper (wholesale price + Downstream cost)}$
- If NGA premium exists, not including it in “competition migration test” may also be relevant: appropriation of the NGA premium by the NGA investor leading to a socially efficient level of investment.

“Competition migration test” support commercial negotiation of fair fixed wholesale

Competition migration test: impossibility for the investor to lower its prices to attract the maximum of customers

NGA profitability dependent of a large migration of customers

Customers' migration generated by the migration of alternative operators

Constraint in investor's behaviour
Investor needs to agree with competitors on a wholesale fixed price that allows him to access NGA infrastructure

provides bargaining power to access seekers to negotiate fair wholesale access fixed (and variable) price

Negotiation between investor and access seekers on fixed wholesale price under “competition migration test”

- Under competition migration test, all parties need to reach agreement
 - Incumbent profit depends on competitors’ customers migration
 - Competitors:
 - commercial risk to leave incumbent alone on NGA market
 - let another competitor be first to reach agreement with incumbent
- Once one agreement reached, strong pressure for incumbent to agree with other competitors on their fixed fee
 - NGA competitor may undercut NGA retail price;
 - Rivals negotiate access with incumbent or initial competitor.
- When retail NGA market competitive, transitory “competition migration test” removed.

Other Parameters for the ERT – Efficiency Standard and Relevant Time Period

- Efficiency standard:
 - Equally Efficient operator test (EEO)
 - Exceptional “adjustments” foreseen in Annex II to the Recommendation undermine legal certainty
 - ERT part of non-discrimination obligation - no need for adjustments to allow sustainable market entry
- Relevant time period
 - DCF multi-period approach
 - Period-by-period analysis not appropriate in view of objective to allow pricing flexibility

Other Parameters for the ERT – Relevant Products

- Flagship products
 - Portfolio approach: test should be limited to dominant retail (bundle) products, no product-by-product test
 - I line with multi-service nature of fibre and the desire to allow price flexibility
- Relevant wholesale product
 - Test should be carried out on most relevant wholesale product in an area with homogeneous competitive conditions
 - In presence of geographic market segmentation or remedies segmentation



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