

ETNO Reflection Document on BEREC draft guidance on the regulatory accounting approach to the economic replicability test



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1. Introduction - purpose of the BEREC draft report and relation to the Commission Recommendation

ETNO welcomes the present consultation by BEREC on the regulatory accounting approach to the economic replicability test (ERT).

The Commission recommendation on consistent non-discrimination obligations and costing methodologies ("the Commission recommendation") in its Annex II provides detailed guidance with regard to the parameters of the economic replicability test.

Against this background, ETNO encourages BEREC to clearly define the purpose of its document. The format of a report lends itself to a descriptive approach, clarifying current practices and differences to the Commission recommendation. The report should not aim to provide guidance that limits interpretations of the recommendation and its Annex II or deviates from it.

We therefore encourage BEREC to adopt a flexible approach to its guidance where the Recommendation itself leaves discretion and not preclude interpretations fostering the goal to enhance NGA investment that the Commission text would allow.

Similarly, the wording of the draft report on the aim to "*align [...] the current practice of ex-ante margin squeeze tests as applied by NRAs and the main characteristics of the recommended ERT*" (p. 5) may be misleading. Ex-ante margin squeeze tests currently carried out by NRAs may not at equal measure aim to enhance pricing flexibility to support NGA investment as does the Recommendation. A 'mutual alignment' would not take these different starting points into account.

We believe that any supplementary guidance on the ERT should be firmly guided by the set of objectives underlying the Recommendation.

The aim of the Commission recommendation is to establish more flexibility for the network operator investing in NGA, thereby enhancing incentives for broadband investment while continuing to safeguard competition in the market.

ETNO has a number of concerns outlined in this response with regard to the interpretations and guidance proposed in the draft report to give as they run contrary to the stated objectives of the recommendation.

In some instances, BEREC cites objectives that are not aligned with those of the recommendation to justify its findings (e.g. “*Prevent penetration pricing strategies*”, p. 48, “*facilitate market entry*” p. 50). ETNO urges BEREC to clearly recognise that the ERT differs in objectives from standard ex-ante margin squeeze tests applied to legacy copper networks and to reflect this fact throughout the text of its report. The recommendation also clearly makes the distinction.¹ In this context it would be necessary to include the objective of favouring NGA investments in the “primary objective” section in point 4.1 of the BEREC draft. It is an objective that flows from the Recommendation and from NRA practice, but is not integrated in the current text.

2. Scope of application of the Economic Replicability Test

The draft report rightly underlines that the ERT applies in cases without cost-orientated price-regulation. A priori, in the presence of price-regulated NGA wholesale products, an additional ex-ante margin squeeze test (ERT or other) is not required. In face of increasing infrastructure-based competition and taking into account the removal the remaining retail-market in the new list of relevant markets of the Commission, a strong ex ante remedy affecting retail pricing such as the *ex-ante* economic replicability test (ERT) is not appropriate where price controls remain on one or more wholesale products in the market. The objective of the Recommendation was clearly not to introduce additional regulatory burdens for undertakings investing in Next Generation Access networks.

3. Parameters of the Economic Replicability Test

If an NRA identifies an ex-ante ERT as the right remedy to safeguard competition and promote investments it has to choose the appropriate methodology which safeguards pricing flexibility for investing network operators, and which takes into account the structure of the market in question, the conditions of competition and the relevant elements of the product portfolio.

We therefore would like to comment on selected specific parameters analyzed by BEREC.

i) Efficiency Standard

The EEO-Test, as is set out in Annex II of the Commission Recommendation, is the right method to generate a calculation of an efficient operator. The

¹ Annex II: „The guidance provided for the ex-ante economic replicability test referred to in point 56 and in the present Annex is limited to the scope of this Recommendation, which relates to the application of Articles 15 and 16 of Directive 2002/21/EC together with Articles 10 and 13 of Directive 2002/19/EC, and therefore applies in different circumstances than ex ante margin squeeze tests applied on regulated wholesale access prices and is entirely without prejudice to application of the competition rules by the Commission and/or national competent authorities, and to their interpretation by the General Court and the Court of Justice of the European Union.“

recommendation states that “[t]he use of the EEO standard enables NRAs to support the SMP operators’ investments in NGA networks and provides incentives for innovation in NGA-based services.”²

We do not believe that variable adjustments for scale allowed in the Recommendation and the BEREC consultation document are appropriate, however. It is worth reminding that the REO approach, which adjusts the standard for the smaller scale of access seekers, is mainly used to promote entry when introducing competition to the market and not in markets where competition is well established or which have the long-term tendency towards effective competition. The adjusted EEO as well as the REO approach introduce scope for arbitrary adjustments favouring inefficient entry, no longer corresponding to the recommendations stated goal of ensuring an *appropriate balance between ensuring efficient entry and sufficient incentive to invest*. We believe the exceptional circumstances described in Annex II of the recommendation are no longer present on European retail markets for electronic communications.

As stated earlier, the BEREC draft on this point does not reflect the Commission guidance in the recommendation. In the summary on p. 50 (‘relevant downstream cost’, right-hand column), market entry assistance is listed as a distinguishing factor between an ex-post and ex-ante approach to margin squeeze. In both cases, however, the purpose of the test is to address discriminatory behaviour leading to market foreclosure, as witnessed by the fact that the ERT is part of a non-discrimination obligation.

Additionally, adjustments for inefficient (e.g. legacy costs) or economical (e.g. special taxation on infrastructure ownership) circumstances specific to the SMP-operator are not taken into account in the current text. This can overestimate the costs of an efficient operator and lead to higher and economically inefficient prices as well as a potential disadvantage towards other unregulated and more efficient players. An NRA has the possibility to exclude inefficiencies and to consider further circumstances and reflect them in the form of efficiency adjustments.³

ii) The relevant cost standard

- **Need to adjust ex-ante margin squeeze methodology to the NGA environment**

The relevant cost standard and the timeframe over which to carry out the ERT should be guided by the objective of the recommendation to “*guarantee a degree of pricing flexibility*” for NGA investors and to allow players to “*share some of the investment risk by differentiating wholesale access prices according to the access seekers’ level of commitment*”.

The methodology used for the test should moreover ensure that “*the SMP operator is not put at a disadvantage vis-à-vis access seekers regarding sharing of the investment risk*” (Annex II).

The NGA investment case spans from just under a decade to several decades, inter alia depending on the degree of fibre roll-out in the access network. The short

² Recital 64, in the recommendation of the European Commission on the non-discrimination and costing methodologies.

³ Cf. Price squeezes, foreclosure and competition law – principles and guidelines, Case Associates – Cento Veljanovski: „As a general rule, the downstream costs used should be the lowest of either downstream firms or the downstream division of the vertically integrated firm.“ ()

term balance of such investments is negative. Long run profitability over several decades in a market increasingly characterized by competing platforms and fast market developments is far from assured. As the Commission pointed out in its broadband Communication of September 2013 *“Legal certainty is particularly important given that investment in fast broadband networks incurs significant costs, while demand for end products remains uncertain.”*

An imbalance occurs if the access seeker is guaranteed a profitable business case recovering all his downstream and upstream costs under a LRIC+ standard over the average customer lifetime, while the investor's balance is clearly negative over the same timeframe. With a wholesale access price adjusted for the test, there are guaranteed profit for access seekers and a 'guaranteed deficit' for upstream investors, putting the investors at a disadvantage vis-à-vis the access seeker and thereby undermining investment incentives.⁴

Several ways can be envisaged to remedy this imbalance:

- **Use of avoidable costs**

BEREC proposes to use a Bottom Up-LRIC+ - or an FAC⁵ - standard for defining the relevant costs of an efficient operator. We believe the use of an avoidable cost (or LRIC) standard would be more appropriate in the context of the economic replicability test.

The aim of ERT is to avoid misuse of market power and resulting foreclosure of retail markets. ETNO is convinced that in order to control abusive behavior the avoidable cost standard is the appropriate cost standard, as used by competition authorities.⁶ Given the similar purpose of the test it should also be used for ERTs. It is worth noting that the initial Commission proposal for the Recommendation suggested an avoidable cost standard (“incremental cost (equivalently, the avoidable cost”), which was later changed to LRIC+. We assume that the Commission changed its draft based on BEREC's opinion⁷, which said that “to promote effective retail competition, it may be necessary to allow for the recovery of joint and common costs”. However, the ERT does not have as main objective to promote retail competition, but should be balancing the need to promote efficient investment and safeguarding competition by guaranteeing replicability.

An elimination of the mark up for joint and common costs is also more consistent with risk sharing - we see no reason to ensure recovery of the full costs incurred by the access seeker including common costs, which are not incremental to the relevant activity, while the profitability of the investor is far from assured. It is also in line with margin squeeze tests under competition law as noted in the Access Notice (1998), para 114⁸ and the Commission communication about guidance on article 82 (feb 2009), para 26 and 80.

⁴ For a more detailed analysis s.: Jaunaux/Lebourges, Economic replicability tests for next generation access networks, EUI Working Papers (FSR), RSCAS 2014/75.

⁵ The use of FAC in the ERT would encounter major concerns. Firstly, these costs are backward looking. Secondly, they will include historic inefficiencies which should not be taken into account in the model.

⁶ Cf. e.g. Cento Veljanovski, “Margin squeeze: An overview of EU and national case law” in e-Competitions, Competition Laws Bulletin, p. 6, para 38.

⁷ BEREC opinion on the “Commission draft Recommendation on the non-discrimination and costing methodologies.” Of 26 March 2013.

⁸ “The Access Notice proposes that “total costs incremental to the provision of the service, and in many cases the Long-Run Average Incremental Average Cost (LRAIC), be used as the cost floor.” (Cf. e.g. Cento Veljanovski, “Margin squeeze: An overview of EU and national case law” in e-Competitions, Competition Laws Bulletin, p. 6, para 39)

In the specific context of the ND and Costing Recommendation, the ERT moreover does not have the task of controlling the price setting of a monopolistic operator, but to safeguard economic replicability in a market where competitive pressure from competing infrastructures already exists and parallel NGA infrastructures may be operated.

Where in such circumstances an ex-ante margin squeeze test is used to prevent a potential foreclosure of the NGA retail market, NRAs should not limit the pricing opportunities of an NGA investor by using costs standards developed for the legacy infrastructure. The use of avoidable cost best captures this market situation.

- **Use of LRIC+ only for the variable part of the access price**

Alternatively, only the variable part of the access price calculated at LRIC+ should enter the ERT calculation where risk sharing arrangements are concluded in the market.⁹

As recognized in the Commission Recommendation, the relevant wholesale price is the price effectively charged including volume discounts and long-term agreements.¹⁰ Although the SMP operator is able to offer different risk commitments, the ERT should in principle be based either on his own risk based on the assumption that an efficient access seeker would commit to the same risk elements as the investing NGA network operator, or on the effective variable wholesale price charged to the access seekers that have entered a risk sharing arrangements.¹¹

Since there are various risk sharing models throughout Europe (from Joint Ventures to build common infrastructures to simple economic commitments such as upfront payments) the parameters and the structure of an ERT should reflect the risk of the investing NGA network operator. The ERT therefore has to be executed differently depending on the details of the risk sharing model in place.

We argue that such an approach does not offer the regulated operator the ability to foreclose the retail market by setting an arbitrarily high fixed share of the access price. In the context of the recommendation, a situation is present where significant pricing constraints from other infrastructures - alternative platforms or the copper network - exist. Against this background, the investor has an own incentive to develop the market together with access seekers prepared to share the

⁹ Risk-sharing wholesale prices for NGA access are supported by 2009 framework, the Commission's NGA Recommendation and the Commission Recommendation on non-discrimination and costing methodologies. Risk sharing can take the form of lightly nonlinear prices, through volume or time discounts, or more heavily nonlinear prices, through upfront payments or co financing. In the present response, we consider all these as two part tariffs, one part directly proportional to the volume of access (variable) and the rest considered as fixed.

¹⁰ We believe that BEREC makes a misleading interpretation of sub paragraph 6 of ANNEX II (iii), regarding the section "Relevant wholesale inputs and the relevant reference prices", both on page 12 and footnote 15 and on page 34 para 3 of the draft report, when referring to "access regulated but not price regulated" input. We understand that the EC refers to the wholesale inputs involved in the ERT and states that NRA should consider the access price that is effectively charged, namely taking into account the presence of volume discounts (against the standard price).

¹¹ Cf. Plum Consulting, "Delivering the new EU approach to fibre: combining pricing flexibility and non-discrimination", September 2012, p. 11: "In relation to term and volume discounts the wholesale discounted price should be used in assessing margin squeeze since this price reflects an equivalent sharing of risk between the investor and access seeker."

investment risks, in order to allow a profitable use of the new infrastructure (and considering that wholesale revenues form part of the NGA business case).¹²

Where an NRA monitors and might intervene in the terms of the risk sharing agreement (the proportion of fixed and variable price), a risk of foreclosure is also absent. Such an approach would arguably be outside the scope of the regulation in that the wholesale is subject to price control.

- **DCF over the infrastructure lifetime for part of the cost**

Another option to align the ERT with the NGA investment case would be to carry out DCF over the infrastructure lifetime for upstream wholesale costs (discussed here instead of below under “relevant timeframe”).

This approach is economically consistent as it aligns the relevant timelines for the investor and those access seekers who are engaging in the market for a long timeframe, providing sustainable and efficient entry. The long time frames considered, especially for Fibre-to-the-home investment, on the other hand increase regulatory discretion, as today’s access price may depend on assumptions on fibre penetration in several decades. Therefore, care should be taken that assumptions err on the side of the investor if this method is used for NGA projects with a long payback period and that the investor enjoys some control over the market migration to NGA.

- **Breakdown of retail costs**

BEREC should not be over-inclusive when it gives a recommendation for the breakdown of the retail costs. The traditional breakdown used by the NRAs for their present ex ante price squeeze test should therefore not be used. As stated in recommend 56, the NRA should only take the relevant downstream stream costs into account.

iii) The relevant time period

ETNO believes that a dynamic, multi-period DCF-approach as foreseen in the recommendation is a suitable approach. The ERT has to take into account the business case calculation for the access seeker over the full relevant time period for consumer downstream costs (over the customer lifetime) and infrastructure costs (over the infrastructure lifetime, as recognized on p. 35 of the draft report) respectively. This enables the regulated operator to act flexibly and offer competitive retail prices, which in turn supports the aim of investment in NGA networks. Usually business cases are based on wholesale product lifetime and long run calculation models to make investment decisions based on underlying assumptions on future costs and revenues. The investing NGA network operator will have a disadvantage if he is not able to offer flexible pricing models and calculate the costs and profits over the lifetime of the investment.

As regards the average customer lifetime, the recommendation refers to the NGA flagship product, which is usually a bundled offer. A mixed calculation with copper products as proposed by BEREC appears inappropriate under the recommendation. Operators invest in a new network with the hope to provide more and better services than the ones already on the market. Therefore, it can be assumed, and is confirmed by initial data, that the customer lifetime on the new

¹² For situations where market foreclosure strategies via the setting of an excessive fixed access price remains possible, Jauniaux/Lebourges, idem, p. 6 ff., propose that an additional “competition migration test” is applied for an intermediate period until the market for NGA offers is competitive.

technology should be longer than the one for traditional broadband products. We recommend using this longer expected lifetime in the ERT.

iv) Relevant wholesale product

We agree with the approach of carrying out the test on the most relevant access product. The interpretation provided by BEREC that the use of an individual mix of different legacy and NGA products is the appropriate method is in contradiction to the recommendation which refers to both NGA wholesale and retail products. The test should be carried out with an efficient access seeker in mind, which seeks to offer the newest technology to its customers, thereby contributing to the profitability of the overall NGA investment. Hence the relevant wholesale product is the most relevant NGA access product. This wholesale product may be different in different geographic areas.

v) The relevant retail products

- **Need for a portfolio approach**

The BEREC guidance in our view does not correctly interpret the Commission Recommendation with regard to the relevant aggregation of retail products in the ERT. The Recommendation says “NRA should assess the most relevant retail products including broadband services (flagship products)” (Annex II (iv)). This clarifies that the ERT should be calculated on a portfolio of retail products. Also BEREC identifies that the product-by-product method would not allow much flexibility for competitive retail offerings for NGA network operators (p. 25) and in fact less incentives to invest. It is worth noting that BEREC, in its opinion on the draft Recommendation, states that *“if the prevalent competitive conditions are such that the regulatory objective is granting more flexibility to the SMP operator, a greater level of aggregation could be more appropriate.”*¹³

A portfolio approach meets the need for flexibility of the investing operator to do service-price differentiation and price adaptation over time and reflects the fact that fibre is a multi-service platform with potentially multiple retail services, often in the form of bundles. The conclusion is to use a portfolio of retail products for the ERT which includes products for new and existing customers, bundles and variations with the potential for flagship products. This observation does not change in the case NRAs would identify a niche product only relevant to a particular access seeker as a flagship product.¹⁴ Also in that case the product should be included in the portfolio of all identified flagship products for the purpose of the ERT (the Recommendation states: “NRAs may decide to include such a product *among* the flagship products.”) Focusing on one single niche product would favor inefficient competition, which is not in line with the principles of the recommendation and the goal of the ERT to ensure replicability of flagship products.

For the calculation of the value of the portfolio NRAs have to take into account the usual business model of competitors of the investing NGA network operator that compete on a portfolio of products, mostly in the form of bundles. We agree that

¹³ BoR (13) 41, BEREC Opinion on Commission draft Recommendation on non-discrimination and costing methodologies, p. 33, fn. 45

¹⁴ “NRAs should consider whether a particular retail product, which may not be among the most relevant retail products of the SMP operator, is particularly attractive to alternative operators that may focus on a certain niche or lower quality retail products.”

this may include discounted prices, but in cases of short or regional promotions they have to be weighted with the non-discounted prices of the portfolio.

The BEREC presentation at the Stakeholder forum claimed that the use of a product-by-product approach ensures that each bundle/standalone product offer is replicable and that there can be no form of cross-subsidisation between bundles/standalone offers. Such an approach would not be in line with the recommendation's clear focus on flagship products.

With regard to cross-subsidization, the recommendation indeed specifies that *"In order to exclude cross-subsidisation between different products in a bundle or portfolio, NRAs should conduct only a single-level test, i.e. between the retail services and the most relevant NGA access input for the access seekers (for example fibre access at the cabinet, virtual unbundling)."*

We believe that this sentence should not lead NRAs to undertake a narrow ERT analysis, especially not a product-by-product test. The Commission clearly states that flagship products can be bundles and this is in line with the present way in which customers buy their telecom services. If the flagship product is a bundle, then there is no justification to apply an ERT to the standalone products. It is worth reminding in this respect that the ERT has no relation with an investigation into possible cross-subsidisation within a bundle. We invite BEREC to stay focused on the goals and objectives of the ERT within the Recommendation in this regard.

- **Need to take into account all relevant revenues and costs**

We also agree that all relevant revenues of downstream services attributable to the bundle have to be taken into account. Non-regulated services are also part of bundles which are typically realized in the market. This includes of course direct revenues like traffic or calls but also options and services like VOD TV offerings, Router, safety-packages or cloud-services. A competitor takes all this revenues and costs into account and might calculate a lower monthly signal-price for the bundle because he gets high revenues with additional services. An efficient operator would calculate with the revenues of the average typical usage of a customer and the production costs for these services. Because most of the NRAs, as the questionnaire shows, are not familiar with unregulated components like content rights, any calculation in this area has to be approached carefully. For example, the content included in the IPTV services have substantial upfront acquisition costs. In such cases, operators would base their business plans on the expectation of recovering the investment through the progressive increase in the number of users during several years.

vi) Reasonable profit

As BEREC correctly observes, the recommendation does not set out guidance on a reasonable profit, but states that the products under evaluation in the ERT should not have a negative margin. We note that the recommendation does not speak of any profit indicator and does not refer, as the draft BEREC guidance does in 3.2.2 and 4.2.2, to a WACC.

Moreover, when the draft states that *"The margin could be expressed as an absolute value or a percentage share of the total costs or the retail price."*, this gives the impression that it's BEREC's view that operators need to realise the same margin on each individual product. This is contrary to the rational of an NGA business case in which all products of a portfolio do normally not contribute in an equal way. That is why

the ERT needs to be applied to the complete portfolio of flagship products (s. above), and accordingly also the margin should be seen in this perspective.

In this context we note that BEREC in its draft guidance wrongly cites the Recommendation regarding the make-or-buy decision in relation to the ERT (p. 32). In fact the Recommendation refers to this concept in the context of cost orientation: “A costing methodology that provides the appropriate ‘build-or-buy’ signal strikes an appropriate balance between ensuring efficient entry and sufficient incentives to invest and, in particular, to deploy NGA networks and hence deliver new, faster and better quality broadband services.” (Reco, recital 27). The Recommendation does not use this concept in relation to ERT, where it in fact would have the opposite effect (additional margin in the ERT would unduly push down the wholesale price to the detriment of the alternative operators ‘build’ decision).

vii) Procedural aspects - ex-ante ERT shall not result in ex-ante regulation of retail markets

As set out in earlier work for ETNO, the ‘ex-ante’ ERT should not be as an additional regulation procedure on retail products. In fact, retail markets have just been fully deregulated under the revised Commission recommendation on relevant product and services markets.¹⁵ The actual application of the test should remain complaints-based.

An ‘ex-ante’ ERT means that the process is based on the ex-ante SMP framework following the finding of SMP on a relevant wholesale market, that it is carried out by NRAs, not by competition authorities and that its parameters are known ex-ante. Etno insists upon transparency and predictability in the setting of parameters of the economic replicability test in order to avoid unnecessary cost to the investor.

An early ex-ante communication of new retail tariffs and discounts to the NRA, as described on p. 36 of the BEREC draft, however, prevents the commercial flexibility and an adequate time-to-market of our products and therefore discriminates the investing NGA network operator. In this sense, an ‘ex post’ control is sufficient if the NRA makes the parameters of an ERT transparent. This is of particular importance in markets characterized by intense platform competition. An additional regulatory process before product launch would severely distort competitive dynamics between competing platforms to the detriment of the regulated operator and ultimately consumers.

¹⁵ Plum Consulting, idem, p. 11