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for Electronic Communications
BEREC

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BEREC Opinion on

Phase II investigation

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

Case SK/2018/2051

Market for wholesale voice call termination on individual public telephone networks provided at a fixed location (Market 1) in Slovakia

4 April 2018

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1. EXECUTIVE SUMMARY

On 22 January 2018, the Commission registered a notification from the Slovakian Regulatory Authority, Úrad pre reguláciu elektronických komunikácií a poštových služieb (RÚ), concerning termination rates in the market for wholesale call termination on individual public telephone networks provided at a fixed location in Slovakia (in light of the fourth market review[1]).

In the notified measure, RÚ proposes to set a maximum symmetric fixed termination rate (FTR) of 0.0976 EUR/cent per minute on the 17 SMP operators, which had previously been designated with SMP.

On 20 February 2018, 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. The Commission expressed serious doubt over the size premium RÚ added into its calculation of the weighted average cost of capital (WACC) to compensate Slovakian operators for their relatively smaller size and higher risk compared to European operators. In line with the fourth market review, the termination of calls originated outside the EU/EEA is excluded from the price control obligation.

According to RÚ, the size premium would reflect the risk of the variability in the return of the operators' shares in the long run depending on the size of undertakings, and is derived from the market capitalisation of the companies listed on the US stock exchange.

On the basis of the analysis set out below, BEREC considers that the Commission's serious doubts are justified. BEREC suggests that RÚ could amend or withdraw the remedies relating to price caps for fixed call termination services in Slovakia in order to ensure that the size premium mark-up is not included in the WACC calculation.

2. INTRODUCTION

On 22 January 2018, the Commission registered a notification from the Slovakian Regulatory Authority, RÚ, concerning termination rates in the market for wholesale call termination on individual public telephone networks provided at a fixed location in Slovakia.

On 31 January 2018, a request for information (RFI) was sent to RÚ, and a response was received on 5 February 2018. Supplementary RFIs were sent on 5 and 6 February 2018, with responses received to those RFIs on 6 and 7 February 2018 respectively.

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 February 2018. In accordance with the BEREC rules of procedure, an Expert Working Group (EWG) 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.

[1] The fourth market review was notified to and assessed by the Commission under case SK/2016/19554 (C(2016) 8842 final).

On 28 February 2018 the EWG sent a first set of questions to RÚ. Answers were received from RÚ on 2 March 2018. A second set of questions was sent to RÚ on 6 March 2018 and the answers were received on 7 March 2018.

The EWG met on 5 March 2018 in Dublin, Ireland[2]. During this meeting the EWG conducted an interview with RÚ by teleconference call, in order to gather further information and clarification on the questions sent, and to discuss additional matters around the serious doubts raised by the Commission. The overall objective of the EWG was to reach clear conclusions on whether or not the Commission's serious doubts are justified.

On 13 March 2018, the EWG held a conference call with the Commission upon the EWG's request. On this occasion the Commission explained in detail to the EWG the reasons behind its serious doubts. This gave the EWG a more complete understanding of the case.

A draft opinion was finalised on 3 April 2018 and adopted by a majority of the BEREC Board of Regulators on 4 April 2018. This opinion is now issued by BEREC in accordance with Article 7a(3) of the Framework Directive.

3. BACKGROUND

Previous notifications

The fourth market review was notified in November 2016 under case SK/2016/1955. RÚ defined the market geographically to correspond with the coverage area of the respective operator's network in the territory of Slovakia, and limited the product market according to the following:

- termination of calls in the fixed network on geographic numbers of end users regardless of origination;
- termination provided either by traditional PSTN, optical networks, cable (CATV) networks, wireless FWA/WiFi networks or mobile network if the end users' services mobility is limited; and
- the Home/Corporate lines provided by Orange Slovensko.

RÚ designated 17[3] undertakings with SMP and imposed the following remedies on all SMP operators:

- access to specific network facilities;
- non-discrimination;
- transparency; and
- price control based on a pure BU-LRIC cost methodology.

[2] A videoconference was also involved for those members of the EWG who could not travel to Dublin on that date.
[3] Slovak Telekom, BENESTRA, Slovanet, Orange Slovensko, Ipfon, Swan, ZSR ZT, UPC, VM Telecom, DH Telecom, ANTIK, DIALOGA, Digitale, O2 Slovakia, Phoonoi, UAB „Raystorm" and VNET.

RÚ specified that the fixed termination rate would be set in a separate procedure[4] and that the termination of calls originated outside the EU/EEA was excluded from the price control obligation. At that time, the Commission had no comments[5].

Current notification and the Commission's serious doubts

Summary of current notification

The notified draft measure concerns the proposal to set the maximum symmetric fixed termination rate (FTR) of 0.0976 EUR/cent per minute on the 17 SMP operators. RÚ initially intended to apply the new FTR as soon as possible after the Commission's adoption, if no comments[6] were made, and that the rates should be valid for a period of 3 years. The maximum tariff was calculated through a pure BU-LRIC model.

With the current notified measure, RÚ assesses the Weighted Average Cost of Capital (WACC) and proposes to set it at the level of 5.21%.

RÚ calculates the cost of equity based on the Capital Asset Pricing Model (CAPM) using the following formula:

$$R_e = R_f + \beta * (R_m - R_f) + \mathrm{SP}$$

Where R_e stands for the cost of equity (own capital), R_f is the risk-free rate, β is the equity beta and R_m is the average return on the market portfolio. 'SP' is a 'business size surcharge' or 'size premium' published annually, according to a study by Duff & Phelps: Valuation Handbook[7].

According to RÚ, the 'SP' would reflect the risk of the variability in the return of the operators' shares in the long run, depending on of the size of undertakings, according to the Duff & Phelps study, and which is derived from the market capitalization of the companies listed in the US stock exchange. It is unclear from the notification and from the responses to the RFIs how RÚ derived the size premium mark-up on the WACC. According to the Commission, the justification of the mark-up is also unclear.

Regarding the equity beta, RÚ used data on a peer group of European Union fixed network operators, with values that adjust the estimated beta towards 1, based on the general assumption that betas have a long-term tendency to converge towards 1.

Summary of serious doubts

Mark-up for company size in the WACC calculations

[4] The current FTRs, notified under case SK/2013/1455 (decision C(2013) 3830 final), result from the pure BU-LRIC methodology (notified under case SK/2012/1367) and amount to 0.1234 EUR/cent per minute.
[5] C(2016) 8842 final.
[6] Because of the Phase II process, RÚ's intention is to apply the new FTRs from 1 June 2018, if the Commission withdraw their serious doubts.
[7] https://www.duffandphelps.com/insights/publications/cost-of-capital/duff-and-phelps-2017-valuation-handbook-guide-to-cost-of-capital

The Commission considers that application of a size premium mark-up in the WACC calculation, that intends to reflect the risk of variability in the return of the operator's shares in the long run perspective depending on the size of undertakings, is neither in compliance with Article 8(2)a and 8(5)d of the Framework Directive nor with Article 13 of the Access Directive.

As already stated by the Commission in case SK/2017/2010 and case SI/2018/2050, such a size premium mark-up is not commonly applied by other NRAs in the EU and does not constitute a common regulatory practice.

The Commission consider RÚ's justification for the size premium to be insufficient, and states that the traditional parameters of the WACC formula should be able to fully account for the non-diversifiable risk of the firms. The Commission notes that it would appear more appropriate for RÚ to have calculated the equity beta of the Slovakian regulated firms, rather than using a peer group, in order to capture company specific risks.

In the absence of any valid justification provided by RÚ, the Commission considers that the size premium mark-up should not be included in the WACC calculation as it would lead to an overestimation of the cost of equity which is likely to have a significant impact on the WACC, and consequently a significant impact on the FTR.

It is the view of the Commission that the WACC value proposed by RÚ, being based on an unjustified size premium, does not promote efficient investment, innovation and competition in the relevant market. As a consequence of this, in the Commission's opinion, consumers may not receive the maximum benefit in terms of choice, price and quality.

4. ASSESSMENT OF THE SERIOUS DOUBTS

On 20 February 2018, 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.

The Commission's serious doubts concern the compliance with EU law of RÚ's draft measure in its current form, in particular with the requirements referred to in Articles 8 (2) (a) and 8 (5) (d) of the Framework Directive in conjunction with Articles 13 (1) and (2) of the Access Directive. The Commission expressed serious doubts that the WACC value proposed by RÚ, which included an unjustified size premium, promoted efficient investment and innovation.

The following sections of this BEREC Opinion analyse the Commission's serious doubts by describing BEREC's assessment of the serious doubts relating to the mark-up for company size in the WACC calculations. In summary, these serious doubts are that:

- In contrast to RÚ's claims, the use of such a size premium mark-up is not a common practice;
- The principle of including a size premium was not sufficiently justified by RU; and
- The derivation of the value of the size premium used by RÚ was not sufficiently explained.

BEREC considers the Commission's concerns, the views of RÚ, and presents its assessment of each of these points in turn below.

Whether a size premium is commonly applied by other NRAs in the EU

Concerns of the Commission

In explaining the concern, the Commission reiterated that as already stated in cases SK/2017/2010 and SI/2018/2050, such a size premium mark-up was not commonly applied by other NRAs in the EU and did not constitute, in the Commission's view, a common regulatory practice.

Views of RÚ

In response to the RFI, RÚ explained, similar to the notified case SK/2017/2010, it included an enterprise size mark-up. RÚ also noted that since there was no harmonised process for calculating the WACC at the European Union level, it considered the use of the size premium to be correct.

In its response to the EWG's questions, RÚ also drew attention to the fact that the Slovakian NRA was not the only regulatory body applying the size premium when calculating the WACC; RÚ referred the EWG to case SI/2018/2050, which is ongoing.

BEREC's Assessment

The methodology for calculation of the cost of equity, i.e. the inclusion of a size premium was the same as case SK/2017/2010 and although RÚ drew attention to the ongoing case SI/2018/2050, the EWG noted how the 2017 BEREC report 'Regulatory Accounting in Practice'[8] states that the most common approach used by NRAs to estimate the cost of equity was to use the CAPM. Furthermore, it did not discuss the inclusion of a size premium when using CAPM.[9] It should be noted, however, that the 'Regulatory Accounting in Practice' report is a fact-finding exercise and does not aim to identify best practices or set recommendations for NRAs.

[8] http://berec.europa.eu/eng/document_register/subject_matter/berec/reports/7316-berec-report-regulatory-accounting-in-practice-2017

[9] See page 4, 2017 Regulatory Accounting in Practice – WACC (BoR (17) 169), available here: http://berec.europa.eu/eng/document_register/subject_matter/berec/reports/7316-berec-report-regulatory-accounting-in-practice-2017

As such, BEREC agrees with the Commission that the use of a size premium is not commonly applied by other NRAs in the EU when estimating the cost of equity using the CAPM, but it also notes that, for the time being, there are no binding law resolutions addressing the use of size premium for WACC calculations.

The lack of sufficient justification for the inclusion of a size premium in WACC calculations

Concerns of the Commission

The Commission did not consider the justification for the size premium provided by RÚ to be sufficient. The Commission considered that the traditional parameters of the WACC formula should be able to fully account for the non-diversifiable risk of the companies, including the risk of Slovakian companies.

The Commission also stated that RÚ seems to have already captured the inherent non-diversifiable risk of the Slovakian operators by the use of the Slovakian government bond and taking into account the gearing of the Slovakian regulated companies in the overall gearing value. The Commission also suggested that it would be more appropriate for RÚ to have calculated the equity beta of the Slovakian regulated firms, rather than using a peer group in order to capture company specific risks.

Views of RÚ

RÚ stated that the standard application of the CAPM does not perform well for smaller companies. The notion that the aim of the size premium is to capture the unsystematic risk is based on the assumption that all unsystematic risk can be eliminated by holding a perfectly diversified portfolio of risky assets.

RÚ pointed to several empirical studies concerning the size premium mark-up in the WACC calculation. These studies confirm that overall revenues achieved in smaller undertakings were considerably higher during a longer time period than the original formulation of the CAPM would have predicted. The value of beta is indirectly associated with the size of the undertaking. RÚ also stated that the size surcharge is represented by the fact that investors expect higher risk-based returns, which are generally higher for lower-capitalised undertakings than for larger ones. RÚ stated that larger undertakings tend to be better established in the market and therefore investors are more willing to accept a lower, stable yield.

Furthermore, RÚ also stated that if the size premium was excluded from the WACC calculation, the WACC would be equal to a value between 3% and 4%[10], which would be the lowest value in the European Union. Excluding the size premium parameter, for the purpose of calculating the price of termination of voice calls on public telephone networks at a fixed location, would be a non-transparent and non-consistent procedure by RÚ, because the methodology, applied as a normal practice by RÚ since 2008, would not be used in the existing markets. The calculated FTR price would decrease by 4% were the WACC to be adjusted.

[10] RÚ requested that the actual % not be published, rather a range be provided.

BEREC's Assessment

In considering the appropriateness, in principle, of including a size premium in the calculation of the cost of equity (for purposes of setting the WACC), BEREC recognises that consideration of company size is discussed in academic literature. While RÚ referenced evidence to support a size premium adjustment, more recent literature on the existence and magnitude of a size premium supersedes the research cited by RÚ.[11] [12]

BEREC agrees with the Commission that the conventional application of the CAPM should be able to appropriately capture the non-diversifiable risk associated with the regulated Slovakian company. BEREC also agrees with the Commission that some non-diversifiable risk is already incorporated since RÚ used the Slovakian government bond to calculate the risk free rate, taking into account the gearing of the Slovakian regulated companies in the overall gearing value.

Based on the above arguments, BEREC is of the opinion that the statement of RÚ, that the CAPM is not applicable for smaller companies, does not hold. Also, the point that RÚ makes about the value of the WACC and the FTR is not a justification, as having a relatively low WACC is not sufficient justification for including a size premium. BEREC is aware that RÚ has previously applied the adjustment to the WACC calculation, and this was not the subject of a Commission serious doubt.

However, in light of discussion with the Commission on this matter, BEREC also understands that the Commission has applied a deeper analysis to the different elements in the cost calculations, including the cost of capital, thus leading to the serious doubt in case SK/2017/2010, case SI/2018/2050, and in this current case. Therefore, it is BEREC's view that the absence of serious doubts in previous notifications does not justify the inclusion of a size premium in this notification.

Overall, BEREC agrees with the Commission that the inclusion of a size premium has not been sufficiently justified by RÚ.

The derivation of the value of the size premium used by RÚ

Concerns of the Commission

The Commission stated that RÚ did not provide sufficient information on how it reached the value of the size premium of between 1% and 2%[13].

Views of RÚ

In response to BEREC's questions, RÚ explained that the value of the size premium used was calculated based on the Duff & Phelps 2017 Valuation Handbook. The size of company capital is between $1,033m[14] and $1,570m[15], which corresponds to the 7th decile and its value is

[11] For a discussion on this matter, see http://aswathdamodaran.blogspot.co.at/2015/04/the-small-cap-premium-fact-fiction-and.html
[12] A literature review of the size effect; Michael A. Crain; Manchester Business School, University of Manchester, UK; Florida Atlantic University, Boca Raton, Florida, USA; The Financial Valuation Group, Fort Lauderdale, Florida, USA; October 29, 2011
[13] RÚ requested that the actual % not be published, rather a range be provided.
[14] Market capitalisation of smallest company.
[15] Market capitalisation of largest company.

between 1% and 2%[16]. In its response to BEREC, RÚ stated the International Financial Reporting Standard equity value of the Slovakian company[17] was $1,155m.

RÚ also explained that the Duff & Phelps study was used because it was recommended by the consultant contracted to conduct the analysis, PricewaterhouseCoopers, as the most common source of size premiums with long history. RÚ further explained that the study was regularly used by practitioners in this field of research, and that no more detailed studies had been prepared for European countries. This is the primary argumentation put forward by RÚ as to why it used the data from the US capital market.

BEREC's Assessment

RÚ provided BEREC with an extract from the Duff & Phelps 2017 Valuation Handbook. The value of the size premium, of between 1% and 2%[18], was taken directly from a table published in this report.

BEREC notes that although RÚ has used Duff & Phelps to calculate the size premium based on the equity value per the Slovakian company's individual financial statements, it has not explained why this value is appropriate for use when calculating the WACC of a Slovakian company.

Furthermore, RÚ's explanation as to the reason for its applicability, i.e. the lack of European data and the argument that it is commonly used by practitioners, does not effectively justify why US data can be used to calculate a Slovakian size premium. The fact that PricewaterhouseCoopers had provided advice to RÚ in 2008 to use Duff & Phelps does not in itself constitute sufficient grounds to apply the size premium to the cost of equity in the WACC calculation.

As a result, BEREC agrees with the Commission that, even if the use of a size premium was justified (and BEREC is of the opinion that it has not been justified), the actual value of the size premium is not sufficiently justified by RÚ.

5. CONCLUSIONS

On the basis of the analysis set out in section 4 above, BEREC considers that the Commission's serious doubts regarding the draft decision of the Slovakian Regulatory Authority concerning termination rates in the market for wholesale call termination on individual public telephone networks provided at a fixed location in Slovakia, as expressed in the Commission's letter to RÚ on 20 February 2018, are justified.

BEREC is of the opinion that the use of a size premium is not commonly applied by NRAs in the European Union when estimating the cost of equity using the CAPM. Furthermore, the inclusion of a size premium has not been sufficiently justified by RÚ. It is BEREC's view that the absence of serious doubts on previous notifications does not justify the inclusion of a size

[16] RÚ requested that the actual % not be published, rather a range be provided.
[17] The equity value of Slovak Telecom (as an SMP operator in Slovakia) as at 31 December 2016. The basis for the WACC calculation for the FTR model was sent only by Slovak Telekom for which was made the peer group.
[18] RÚ requested that the actual % not be published, rather a range be provided.

premium in the current notification. Finally, even if the use of a size premium was justified (and BEREC is of the opinion that it has not been justified), the actual value of the size premium is not sufficiently justified by RÚ.

In light of the Commission's serious doubts and BEREC's analysis and argumentation above, with respect to this case, BEREC suggests that RÚ could amend or withdraw the remedies relating to price caps for fixed call termination services in Slovakia in order to ensure that the size premium mark-up is not included in the WACC calculation. This suggestion is in line with the Commission's recommendation for case SK/2017/2010 as of 22 February 2018[19].

[19] C(2018) 1035 final.