

BEREC Opinion on Phase II investigation

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

Case HU/2018/2107

**Wholesale high quality access provided at a fixed location (Market 4) in
Hungary**

15 October 2018

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Executive summary

On 16 August 2018, the European Commission registered a notification by the Hungarian Regulatory Authority, NMHH, concerning the market for wholesale high quality access provided at a fixed location in Hungary, corresponding to market 4 in Commission Recommendation 2014/710/EU.

The draft measure defines a wholesale market for leased lines encompassing analogue TDM- and Ethernet lines irrespective of bandwidth, supplied through copper, fiber and wireless. The draft measure proposes to designate Magyar Telekom (hereinafter: MT) as the only operator having significant market power in the relevant wholesale market and proposes the imposition of a range of regulatory remedies on MT including access remedies, obligations of transparency and non-discrimination, and price controls.

On 17 September 2018, the European Commission sent a serious doubts letter opening a phase II investigation pursuant to Article 7 and 7a of Directive 2002/21/EC as amended by Directive 2009/140/EC. Commission's doubts concern the SMP assessment, the under-recovery of costs and the mark-up for company size in the WACC calculation. The latter two doubts will be assessed in a separate Opinion.

Based on the economic analysis set out in this Opinion, BEREC considers that the Commission's serious doubts are not justified.

1. Introduction

On 16 August 2018, the European Commission registered a notification by the Hungarian Regulatory Authority, NMHH, concerning market 4. On 27 August 2018, a request for information (RFI) was sent to NMHH, and a response was received on 29 August 2018. On 4 September, a supplementary request for information was sent to NMHH and a reply was received on 5 September 2018.

The Commission initiated a phase II investigation, pursuant to Article 7 and 7a of Directive 2002/21/EC as amended by Directive 2009/140/EC, with a serious doubts letter on 17 September 2018. In accordance with the BEREC rules of procedure, the 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.

On 20 September 2018, the EWG sent a first list of questions to NMHH. Answers were received from NMHH on 21 September, a second list was sent the 24 September 2018 and the answers received the 25 September 2018.

The EWG met on 26 September 2018 in The Hague. During this meeting, the EWG held an audition with NMHH to gather further information and clarification in response to the questions sent the week before and to additional questions. The objective of the EWG was to reach clear conclusions on whether or not the Commission's serious doubts are justified.

A draft opinion was finalized on 8 October 2018 and a final opinion was presented and adopted by a majority of the BEREC Board of Regulators on 15 October 2018. This opinion is now issued by BEREC in accordance with Article 7(5) of the Framework Directive.

2. Background

Previous notifications

The market for wholesale high quality access at a fixed location in Hungary was previously notified to and assessed by the Commission under case number HU/2011/1269. NMHH proposed to split the market into two separate submarkets, depending on the bandwidth (up to 2 Mbit/s, and above 2 Mbit/s, respectively). The defined market included the analogue and TDM based leased lines, but did not include the Ethernet based leased lines. With regard to higher bandwidth leased lines NMHH considered that the structural barriers to entry were transitory, due to high potential returns as well as expected significant growth in that market. Even if the market shares of alternative providers did not increase, NMHH considered that this market tended toward effective competition, hence proposed its deregulation. NMHH designated MT as an SMP operator in the market for low bandwidth leased lines, and imposed on it a full range of remedies, with the exception of price control. The Commission, while in principle not objecting to the split of the markets, commented on insufficient evidence to support such split, and urged NMHH to further substantiate its decision with more up-to-date market information. Similarly, with regard to NMHH's conclusion on the three criteria test (for high bandwidth leased lines) and SMP finding the Commission requested NMHH to substantiate its conclusion with further evidence. The Commission also pointed out that the outdated market data did not allow to draw correct conclusions in a forward looking analysis.

Current notification and the Commission's serious doubts

Market definition

The definition of the relevant market differs substantially, when compared to the previous market review. Firstly, in view of technological developments in this market and the tendency to replace analogue and TDM based leased lines, the market now includes also Ethernet based leased lines. Hence, the relevant market encompasses analogue, TDM and Ethernet based leased line terminating segments. The product market excludes the terminating segments of leased lines used to provide mobile backhaul; NMHH considers that such leased lines are not part of retail leased lines market, and consequently should not be included in the relevant upstream market.

Moreover, NMHH recalls that from 2012 onwards leased lines services provided to public institutions have been gradually taken over by NISZ, as a government service provider. Similarly, leased line services for the purpose of electricity transmission network are provided by MVM NET. In both cases, the service providers are obliged by law to provide leased lines services to the specified customers, and those customers can only use the services of those operators. NMHH argues that those leased lines services are not based on market

transactions, but rather on legal requirements. Due to legal restrictions, those leased lines services cannot appear on the supply nor demand side of the relevant market. NMHH concludes that therefore these services should be excluded from the scope of the relevant market.

Further, unlike in its previous market review, NMHH considers now that the relevant wholesale market should not be divided according to bandwidths. NMHH considers that the increasing use of higher bandwidth products, as well as the overlap between prices for leased lines in adjacent speed classes justify the definition of a single market encompassing all speeds. This conclusion is further supported by evidence of ease of switching to higher speeds, and from analogue to Ethernet based leased lines.

NMHH concluded that the relevant geographic market is national. In that regard, NMHH points to market shares, pricing and behavioural evidence supporting its conclusion that there is a lack of significant differences in supply and demand conditions between former concession areas.

Finding of significant market power

At the outset, NMHH recalls structural changes, which occurred on this market since the last review. It observes a general decline in the number of active leased lines, as well as a significant transformation of the type of leased lines used. In 2016, Ethernet based leased lines constituted the overwhelming majority of total lines, while the number of analogue and traditional digital TDM lines has dropped drastically. It is expected that both TDM and analogue leased lines will no longer be offered in the near future.

NMHH assessed the market shares at the retail, as well as the wholesale level, and with and without self-supply. At the retail level, MT holds a relatively stable high market share (above ).

As the market shares at the wholesale level with the inclusion of self-supply correspond to retail market shares, NMHH also assessed the shares on the merchant market. NMHH highlighted that the shares of the merchant market as such would be misleading since a “vast majority of services on the retail market are based on the internal performance”. The market shares including self-supply correspond with the market shares on the retail market; consequently self-supply should be considered.

NMHH also observed a decline in retail prices in all unregulated segments of the newly defined market, except for Ethernet based leased lines above 500 Mbit/s. However, these services appear to have been priced initially at a very low level.

NMHH found that MT also met other SMP criteria (absolute and relative size, control over infrastructure not easy to duplicate, absence of countervailing buyer power, access to capital, economies of scale, potential competition, entry and expansion barriers). The following indicators do not, in NMHH’s view, point towards MT’s market power: technological advantage, product diversification, economies of scale, vertical integration.

On balance, NMHH finds that MT holds a SMP position in the market for high quality access provided at a fixed location in Hungary.

The Commission raises serious doubts that NMHH's proposed SMP designation is compatible with EU law, more precisely with the requirements laid down in Article 14 and Article 16(2) of the Framework Directive.

The Commission also raises serious doubts on the under-recovery of costs with the proposed price control mechanism and the calculation of the WACC comply with the policy objectives set in Article 8(2)a and 8(5)d of the Framework Directive. The latter two doubts will be assessed in a separate Opinion.

3. Assessment of the serious doubts

On 17 September 2018, the Commission sent a serious doubts letter opening a phase II investigation pursuant to Article 7 and 7a¹ of Directive 2002/21/EC as amended by Directive 2009/140/EC. Commission's doubts, pursuant to Article 7 concern compliance with Article 14 and Article 16(2) of the Framework Directive, in particular:

Concerns of the Commission

The Commission notes that NMHH designated MT with SMP in the part of the relevant market which concerns wholesale terminating segments of leased lines above 2 Mbit/s and that this part of the market did not meet the three criteria in the previous market review. The Commission considers that NMHH has not sufficiently explained the changes in market circumstances that led NMHH to reach a different conclusion in the current review.

Views of NMHH

In the relevant RFI, the Commission asked NMHH to further justify the definition of a market, which includes the provision of wholesale high-quality access irrespective of the bandwidth.

According to its response to the RFI, NMHH takes the view that segmentation of the market would result in a too narrow definition of the market and a false evaluation of market power, since:

1. There is overlap between prices for higher bandwidth leased lines in adjacent speed classes; the use of these leased lines has increased in the period 2012 – 2016. There is a clear chain of substitution.
2. In the case of Ethernet based leased lines, which constitute the large majority of the lines in the newly defined market, the upgrade to higher bandwidth services is not impeded by technological factors either.

¹ Commission's doubts concerning the under-recovery of costs and the mark-up for company size in the WACC calculation will be assessed in a separate Opinion.

Thus, the definition of the market is modified accordingly in order to reflect the above conditions, since in case of a price increase of lower bandwidth services; subscribers would be able to upgrade to adjacent higher-speed leased lines services.

BEREC's assessment

Although the Commission notes that NMHH finds that MT holds an SMP position in a part of the market that in the previous market analysis decision did not meet the three criteria, it does not raise any serious doubts on this specific issue.

Regarding the comment that NMHH has not sufficiently explained the changes in market circumstances that led NMHH to reach a different conclusion now, BEREC notes the following:

1. NMHH notes that, according to its assessment at the retail level, there are no indications for defining sub-markets by bandwidth.
2. The definition of sub-markets by bandwidth with a threshold of 2 Mbit/s in the previous market analysis decision was mainly due to the technical characteristics of the TDM leased lines, since the bandwidth available on a single copper twin-wire is 2 Mbit/s. In the current market review, NMHH has extended the market with the inclusion of Ethernet based leased lines, which have become by far the most important technology. In the case of Ethernet based leased lines the 2 Mbit/s split does not have any special meaning.
3. NMHH identifies different market trends in the market segments above and below 2 Mbit/s. Specifically, the market shares in the two segments show that a significant proportion of subscribers of leased line services with bandwidth less than or equal to 2 Mbit/s have migrated to services with bandwidth higher than 2 Mbit/s.
4. NMHH identifies overlap of prices in the neighbouring speed categories during the period 2012 – 2016. This fact indicates a chain of substitution which enables the migration to higher speeds in case of a price increase in the lower speeds.
5. There have been significant changes in the structure of the market, especially as far as MT's main competitors are concerned:
 - a. Establishment of Invitech with the divestment of the medium and large enterprise business line of Invitel. [REDACTED]
 - b. Acquisition of GTS, one of its main competitors, by MT.

BEREC is of the opinion that NMHH addressed the issue at stake at both a technical and an economic level, while it also considered the significant changes that took place in the period since the last review. BEREC therefore considers that the Commission's concerns about NMHH's insufficient explanation regarding the changes in market circumstances are not justified.

Concerns of the Commission

The Commission notes that the evidence presented by NMHH with regard to the SMP assessment is inconclusive, and there are indications that the market for wholesale high quality access can be considered competitive. This can in particular be inferred from a more detailed assessment of the market shares. While indeed MT's market share remains high, if low and high bandwidth leased lines are calculated jointly, a different picture of the market emerges if the low bandwidth lines were to be excluded. MT's market share in the retail leased lines of higher speeds (above 2 Mbit/s, which will constitute the vast majority of lines over the review period) ██████████ (between 2012 and 2015), and increased in 2016, in effect of merger with GTS. Finally, the Commission notes that MT ██████████ wholesale operator on the merchant market.

Views of NMHH

NMHH concluded that the market definition included all leased lines irrespective of technology or bandwidth. NMHH highlighted in their answers to the RFI that the Commission has not raised any serious doubts about this market definition, thus "*examining and analysing the market with bandwidth segmentation (...) is not correct and misleading*".

Nevertheless, NMHH also pointed out, that ██████████ MT has significantly increased its market power thanks to GTS takeover in 2016, as this operator was ██████████ competitor of MT, but also MT has been able ██████████ purchased from GTS.

Furthermore, NMHH has examined several other factors (e.g. entry barriers, no potential competition) besides market shares with the conclusion that they do not restrict MT's market power. In particular, the controlling power over infrastructure that is difficult to duplicate has been the most relevant factor that significantly changed since the last analysis in 2012 (with data from 2009), due to disinvestment of Invitech, GTS merger and obligation of MVM Net to focus on the supply of MAVIR and NISZ.

Regarding wholesale market shares, it is necessary to include self-supply of vertically integrated operators. The reasons are that the uptake of wholesale services is rather low and that competitive pressure from the retail market is significant.

Finally, NMHH states that data from revenues are not reliable to assess market shares, given that leased lines are sold together with other services. Therefore, the relevant market shares are the ones based on volume.

BEREC's assessment

In order to assess whether SMP exists, the only relevant market shares are those regarding the market definition. NMHH defined the relevant product market that includes all leased lines irrespective of technology and bandwidth. As the EC does not express doubts over NMHH's market definition, the 'market' shares on a specific segment within the whole market are not so relevant. Thus, MT's market shares are high and stable over time. BEREC's opinion is that

reasonable doubts cannot be justified based on a different market definition from the one that was accepted.

Additionally, an indicator of the economic strength of MT is that recently, in 2016, MT managed [REDACTED] with the merger with GTS.

The assessment of retail market shares based on different speed / bandwidth ranges shows that lines up to 2 Mbit/s still represent 35,5% of all leased lines, [REDACTED]. In the range higher than 2 Mbit/s, MT owns [REDACTED] retail lines after the merge with GTS, which is also a significant share.

In addition, the market share is one of the criteria taken into account by NMHH, but not the only one. NMHH has assessed several others, which are indicative of MT's SMP position:

- Absolute and relative size of the business,
- Controlling power over infrastructure that is difficult to duplicate,
- Absence of countervailing purchasing power,
- Easy or privileged access to the capital markets,
- Economies of scale,
- Entry barriers,
- No potential competition,
- Barriers of expansion

Regarding the wholesale figures, BEREC does not agree with the EC's finding that [REDACTED] is a sign of effective competition in the market. The fact is that the total number of wholesale leased lines represents only 11% of the retail market for leased line and that wholesale market size fell by 19% in the period 2012 - 2016. This context leads to the suspicion that:

- Barriers to enter the wholesale market are high.
- Retail demand is not served much by the wholesale offer.
- Operators mostly rely on their own networks to provide retail leased lines.

Ethernet based leased lines, which form the major part of the market (80% of retail leased) have never been regulated. The size of wholesale market represents only 11% of the whole market scope, leading to a conclusion that the retail leased lines on the market are not a result of the prevailing infrastructure operator's attractive wholesale offer. To compare operators, data including self-supply should have been taken into account, not just only wholesale (merchant) market shares. MT's market share including self-supply is high and has been fairly stable during the period 2012 – 2016. Therefore, BEREC is of the opinion that the Commission's doubts on this point are not justified.

Concerns of the Commission

The Commission notes, that the evidence presented by NMHH with regard to the SMP assessment is inconclusive, and that there are indications that the market for wholesale high quality access can be considered competitive.

Regarding pricing behaviour, the Commission observes that in the past leased lines services in Hungary have remained unregulated, except for leased lines up to 2 Mbit/s. Yet, NMHH reports significant price decreases over the last years, in all categories of leased lines (except those above 500 Mbit/s, for which prices increased, albeit from very low levels). According to the Commission, such pricing behaviour is generally not indicative of the exercise of significant market power.

Views of NMHH

NMHH concludes that service providers do not set significantly different prices in comparison with their own concession area or the other concession area of another service. At the same time, however, NMHH compares only the pricing of the same service provider in different areas but does not carry out a comparative analysis of the relative price level of each service provider.

NMHH also emphasises that [REDACTED]. Although no detailed analysis of the relative price level of each provider has been included, NMHH states that [REDACTED] in average pricing levels were noticed since 2012 between MT and other operators.

According to NMHH the year-to-year decline in the average price does not justify excessive pricing can be excluded. NMHH explains that the retail price level can come down, where the SMP provider and the competitors' prices have a high starting point. SMP may exist in such situations, especially [REDACTED] throughout the year. Therefore, NMHH continues to maintain its view that, in the absence of regulation, excessive pricing may also occur in the relevant market in the near future.

BEREC's assessment

BEREC would like to stress, that in general it is rather difficult to obtain reliable price data on retail leased lines markets. This is due to the nature of the market where customers are mainly high-end businesses (or public administrations) who receive tailored integrated offers including, usually, with the same price a great part of their communications needs (such as advanced data services, fixed telephony and broadband, or even mobile communications). When providing pricing data to NRAs for a specific service like leased lines, each operator may decide differently how they assign revenues to each of the services included in the bundle. Additionally, given the rapid evolution of technologies and bandwidth, this assignment may also be modified differently, provoking an extra difficulty when assessing the price evolution. NMHH has given several examples of the difficulties on getting reliable (uniform) data. For instance in the wholesale market the terminating segments are bundled with trunks, and in the retail market leased lines are often supplied in bundles with other retail products.

Other factors that complicate the comparability of price data may be contract lengths, QoS/SLA and establishing costs depending on the customer's needs they all have an influence on the price. BEREC also notes that NMHH has supplied no detailed information regarding operator's costs.

Under such circumstances, determining excessive pricing or comparing price levels between operators can prove very difficult. Thus, there is a potential risk of letting price related data lead to misleading conclusions. Therefore, BEREC is careful to put too much emphasis on pricing behaviour as such in the assessment of SMP on this market.

BEREC agrees with the Commission on its comment that a significant price decrease over the last years is not a priori indicative of the exercise of significant market power. But in this case however, it is clear that the decrease in price level coincided with the migration from TDM to the less costly Ethernet platform. The effect of passing on cost reductions to end-users could have contributed to the decrease in price level. At the same time, MT is [REDACTED] with its nearest competitors while upholding its market share at a high level, as NMHH argues. Being able to do so could be the indication of an SMP operator. BEREC agrees with NMHH when it states that the year-to-year decline in the average price does not (in itself) exclude excessive pricing. Considering the explanations above, BEREC does not support the Commission's doubts regarding the observed pricing behaviour.

Concerns of the Commission

The Commission notes that NMHH has not sufficiently analysed the effects on the market exerted by services, provision of which is reserved by law to specific operators and which have been excluded from the scope of the relevant market, i.e., leased lines provided by NISZ to the government entities and those provided by MVM NET to the operator (MAVIR) of national electrical grid. The Commission is of the view that they should not be disregarded in the assessment of the market.

Also the Commission draws attention to the fact that under the EU legal framework, Member States shall not grant or maintain in force exclusive or special rights for the provision of publicly available electronic communication services.

The Commission recognizes that, because of the legal limitations, the excluded leased line services cannot be placed on the relevant market, nor there is demand-side substitution. Nevertheless, the effects of substitution and migration of the governmental entities away from the commercial suppliers should be considered in the assessment of the competitive constraints faced by market players, even if such constraints stem from outside the relevant market. The consideration of the economic consequences concerning the services provided to the governmental entities is likely to even further decrease the alleged market power held by MT.

Views of NMHH

As there is no substitution, it can be considered neither in the market definition (as the Commission has also noted) nor in the SMP assessment.

BEREC's assessment

BEREC notes that the assessment of the Commission's comment on the legitimacy to grant exclusive rights to NISZ and MVM NET for the provision of leased lines, is outside of the scope of this BEREC opinion. However, BEREC takes it into account to a degree, which is necessary for the assessment of the compliance with Articles 14 and 16(2) of the Framework Directive.

BEREC agrees with the Commission that the excluded services should not be disregarded in the assessment of the market. It is necessary to guarantee regulatory predictability, balance and ensure that the exclusion does not affect the outcome of future market analysis, likewise in case of withdrawal of the exclusive rights in the future based on the EU legal framework as pointed out by the Commission. The objective is to identify whether and to what extent NISZ or MVM NET are capable of constraining MT's behaviour, especially if excluded services represent remarkable volume.

According to draft notification document, MVM NET and MAVIR are members of the MVM Group. MVM NET provides the internal electronic telecommunication network serving for the transmission and electric industry system management activity of MAVIR. As these services could be considered as internal provision of data transmission within MVM Group, it is not likely MAVIR could be a potential customer being part of the competition irrespective of legal restrictions at national level. On the other hand, leased lines provided to government entities would be part of the relevant market under investigation if legal restrictions would not exist.

Moreover, NMHH has not assessed to what extent the infrastructure used to provide leased lines to government entities and MAVIR, technically could be used to provide leased lines to other customers or alternatively, how the existing infrastructure provides the competitive advantage for network extension should there be the need.

Despite that the volume of provided end-points is justifiably excluded from the market share calculation, it could serve as a useful indication of the market structure considering, where appropriate, self-supply and external downstream (retail) provision of leased lines and network coverage. Given the [REDACTED] by these operators, BEREC questions, if such an analysis would have been added, this would have a significant effect on the SMP assessment.

When assessing control on infrastructure not easily duplicated, NMHH concluded that MT possesses the widest access network coverage but did not provide figures of all infrastructure owners to compare, for example, the length of the access network or other available parameters, which characterize control of infrastructure, including the network, which is used to provide excluded leased line services. The length and ownership of civil engineering infrastructure could also be analysed as it indicates on the advantage regarding access network owned and gives the benefit to rollout or extend fibre network faster and at lower costs.

However, there appears to be significant changes in the market e.g. consolidation of MT and GTS as well as reorganisation of an operator INVITEL. Competitive dynamics can depend on different circumstances the Hungarian leased lines market faced since the last market analysis in 2011.

BEREC shares the Commission's opinion that NMHH has not sufficiently analysed the consequences of the exclusion of this segment in terms of the impact it had on the alleged market power of MT and overall competitive dynamics. Despite the marginal effect of such an additional analysis, BEREC considers the Commission's doubts justified on this count.

Concerns of the Commission

The market currently undergoes significant technological changes (migration from analogue and TDM lines to Ethernet), implying less advantage resulting from legacy networks.

Views of NMHH

NMHH notes that most of the TDM services have been already migrated to Ethernet based services. The market volumes of the considered 2012-2016 period clearly show this trend. Therefore, the effect of migration from TDM to Ethernet is already shown in market shares and considered in the SMP assessment. MT has a strong position in Ethernet services as well. Due to [REDACTED] analogue and TDM lines a further significant change in MT's market position caused by the completion of migration cannot be expected. In addition, MT is migrating its TDM/analogue leased line clients in a proactive way to Ethernet based services, so its market position in the traditional leased line services is transferred in a significant extent to the Ethernet based leased line services. It is also important to note that MT has by far the most extensive access network with almost national coverage, which includes the highest number of points of presence and extensive passive infrastructure elements. The extensive access network makes it possible to MT to roll out leased line terminating segments quicker and cheaper than its competitors, independently from the underlying technology. So, the advantageous position is stemming mainly from the extensive network and not from the technology used to provide the service. This situation will not change in the future.

BEREC's assessment

With the migration to new technology, the equipment (switches, routers, gateways) has changed to Ethernet technology but the underlying infrastructure has remained the same. In fact, the basis for an operator to be able to offer leased lines is that this operator is capable of reaching business locations with its infrastructure (ducts, optic fibers, short copper lines).

For this reason, the owner of the main part of the infrastructure is able to impose high barriers to its competitors by making its wholesale conditions unattractive. According to NMHH's findings, MT holds the majority of the infrastructure.

The investment in Ethernet equipment is not an investment for supplementary services but the natural replacement investment for replacement of TDM equipment's end-of-life that is no longer supported by manufacturers.

The operator can continue to provide a service totally comparable with legacy leased lines by means of "circuit emulation" even if most of them do not offer such services.

The opinion of BEREC is that the advantages of TDM networks are passed on to Ethernet networks due to relatively low investments and the continuity of services between TDM and Ethernet. Ownership of (legacy) network remains an advantage.

4. Conclusions

On the basis of the economic analysis set out in section 3 above, BEREC considers that the Commission's serious doubts on the SMP assessment regarding the draft decision of the Hungarian Regulatory Authority on market 4 - as expressed in the EC's letter to NMHH of 17 September 2018 – are not justified.

BEREC is of the opinion that the Commission's serious doubts are not justified with regard to the alleged insufficient explanation of the changes of the market. BEREC also concludes that, given the market definition, the Commission's doubts are not justified regarding market shares on specific segments of the market, and alleged diminished advantages from legacy networks. In addition, the pricing behaviour does not justify the serious doubts of the Commission regarding the SMP assessment.

BEREC agrees with the Commission that NMHH has insufficiently taken into account the effects on the market exerted by services, which have been excluded from the relevant market. According to BEREC, this omission does not justify the serious doubts. Given the data available such an analysis would not have a significant effect on the SMP assessment. Therefore, the overall conclusion is that BEREC considers that the Commission's serious doubts on the SMP assessment are not justified.