Body of European Regulators
for Electronic Communications

BoR (18) 205

BEREC Opinion on
Phase II investigation

pursuant to Article 7a 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

25 October 2018

Contents

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 (SMP) 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. The Commission's doubts concern the SMP assessment, the under-recovery of costs and the mark-up for company size in the WACC calculation. The first doubt was addressed in BEREC Opinion of 15 October 2018 (BoR (18) 199). In this Opinion BEREC will assess the two latter doubts.

Based on the economic analysis set out in this Opinion, BEREC considers that the Commission's serious doubts are partly 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 on 24 September 2018 and answers were received on 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 18 October 2018 and a final opinion was presented and adopted by a majority of the BEREC Board of Regulators on 25 October 2018. This opinion is now issued by BEREC in accordance with Article 7a(3) 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 a 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 its 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 correct conclusions to be drawn 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, therefore, that 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 [redacted]%).

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.

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. According to BEREC, these doubts are not justified.[1]

NMHH proposes to impose on MT the following set of obligations:

– Access: only with regard to terminating segments of leased lines provided over the Ethernet technology. NMHH considers that access over analogue and TDM interfaces is not relevant any more due to the changes of the market, and the expected termination of services provided over the legacy interfaces;

– Transparency;

– Non-discrimination;

– Price control and cost accounting;

– Access to and use of specific network facilities;

– Accounting separation.

With regard to price control, NMHH proposes to allow MT only the recovery of costs directly related to the provision of wholesale terminating segments of leased lines. MT will not be allowed to recover any share of the costs of passive infrastructure, nor common costs (e.g. overhead) through its wholesale charges for services in this market.[2]

WACC

The text of the notified draft measure refers to WACC (Weighted Average Cost of Capital) values as published on the NMHH website. As NMHH's decision concerning the calculation of the WACC has not been previously notified to the Commission, NMHH informed the Commission about its methodology and parameters used for WACC calculation only in the reply to the RFIs. NMHH re-calculates the WACC each year, for the last day of a given calendar year. The most recent WACC has been set at the level of 8%, using the parameters described in the table below.

[1] 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, BoR 18(199), adopted on 15 October 2018.

[2] This price control mechanism appears to differ from than applied for one-way access services on local and central access markets (markets 3a and 3b), where the wholesale fees are set by way of BU LRIC+ cost model.

Parameters and values used by MNHH to calculate WACC	
	WACC value
a) Risk free rate	**3.20%**
b) Debt premium	**0.40%**
c) Cost of Debt	**3.70%**
e) Tax Rate (corporate tax)	**19%**
f) Pre-tax Cost of Debt	**3.7%**
g) Equity risk premium	**6%**
h) Gearing (target)	**39%**
j) Asset Beta (value used for evaluating the equity beta before applying the unlevering formula)	**0.51**
k) Equity beta	**0.78**
l) Post tax Cost of Equity	**8.70%**
m) Pre-tax Cost of Equity	**10.74%**
n) Nominal pre-tax WACC	**8.00%**

The cost of equity parameter is adjusted by a size premium, to take account of the smaller size of Hungarian operators, as compared to the peer group. The adjustment increases the cost of equity by 0.8 percentage points, and consequently increases the nominal pre-tax WACC by 0.61 percentage points (from 7.39% to 8%).

In its reply to the RFI NMHH considers that the 2017 WACC was calculated consistently with the WACC-related study prepared by the Brattle group for the Commission.3 However, NMHH adjusts its calculation by including a 'size premium' in the cost of equity.

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[4] and 7a 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 observes that NMHH proposes to allow MT only the recovery of costs *directly* related to the provision of wholesale high quality access services. From the notification and subsequent reply to the Commission's request for information it appears that MT will not be allowed to recover through the wholesale charges any share of the

[3] The Brattle Group, "Review of approaches to estimate a reasonable rate of return for investments in telecoms networks in regulatory proceedings and options for EU harmonization", 2016.

[4] Commission's doubts concerning the SMP assessment have been assessed in BEREC Opinion BoR 18(199), adopted on 15 October 2018.

costs of passive infrastructure (i.e. infrastructure which is used to provide variety of services on unregulated as well as on other regulated markets), nor the proportionate share of its wholesale operations (administrative costs, overheads, IT systems).

Article 8(2) of the Framework Directive requires national regulatory authorities to promote competition and consumer benefit. According to Article 13(1) of the Access Directive, when imposing cost orientation, national regulatory authorities shall take into account the investment made by the operator, and allow him a reasonable rate of return on adequate capital employed. A cost recovery mechanism, which allows for the recovery of only direct costs, and not those infrastructure costs, which are shared with other services, may not allow a sufficient return on capital as required by Article 13(1) Access Directive. Moreover, given the clear downward price trends in almost all bandwidth categories in a largely deregulated market, as well as the presence of infrastructure competition in significant parts of the country, it seems disproportionate to introduce strict price regulation that would prevent the SMP operator to recover the indirect costs sustained in the provision of wholesale leased lines. Finally, where the costs of replacing or replicating leased lines are above the costs recovered through regulated access prices; this will not promote efficient investments or promote sustainable (infrastructure) competition.

The Commission considers at this stage that the price control mechanism, as proposed for wholesale high quality services, leads to the under-recovery of costs of those services, and is therefore not in accordance with Article 8(2) of the Framework Directive and Article 13(1) and (2) of the Access Directive.

Views of NMHH

<u>Regarding passive infrastructure costs:</u>

According to NMHH, it is not correct that MT cannot recover costs of passive infrastructure. Neither from the notification nor from the subsequent reply to the Commission's request for information it cannot be concluded that MT will not be allowed to recover through the wholesale charges any share of the costs of passive infrastructure.

As the notification states in Annex I, point (5):

"The following costs can be considered direct costs:

a) depreciation of the equipment used to provide the terminating segments in accordance with the undertaking's accounting policy;
b) the capital cost of the equipment used to provide the terminating segments.
c) operating costs directly connected to providing the terminating segments (e.g. cost of operation and maintenance activities"

In the following point (6) the equipment used to provide the terminating segments is specified as**:**

"Leased line terminating segment equipment includes electronic communications equipment directly used to provide services in the terminating segment and the passive infrastructure elements for placing the equipment. If the Obligated Service Provider uses a given piece of equipment (e.g.

substructure) for another service besides the leased line service (including internal services), then it must share the costs of the equipment between the leased line terminating segment and the other service in proportion to their usage. The division of costs between the services must primarily reflect the volume or capacity ratios, expressed in natural units of measurement, related to use of the given equipment."

Regarding common costs:

With respect to common costs, NMHH confirms that MT cannot recover these costs through the access price. The purpose of this provision is to encourage the use of the wholesale service, which is currently relatively low, thus creating alternative retail offers in areas where competitors do not have an infrastructure. According to NMHH in their response to the RFI, without this provision, competitors cannot match MT's price at retail level.

BEREC's Assessment

BEREC notes that Annex I of the decision indeed mentions that MT can only take into account direct costs associated with the Ethernet leased line terminating segment[5]. In accounting the term 'direct costs' is used for costs that can be traced directly, immediately and univocal to a specific product or service, and they are identified in the operator's accountancy system. In other words, direct costs do not need a process of distribution. In case of leased lines a typical example of direct costs are costs of the end-user equipment. However, according to paragraph 6, Annex 1 of the notified draft decision, MT can include costs shared by different services and costs which should be allocated in proportion of their usage. Apparently, these costs are also considered direct costs or costs directly related to the provision of wholesale high quality access services. Thereby, costs related to passive infrastructure used for supplying terminating segments of Ethernet leased lines can indeed be recovered. This interpretation of the articles 5 and 6 was confirmed by NMHH during the meeting in The Hague.

BEREC does not know how the Commission interprets Annex 1, but it means that the text does not reflect the exact position of NMHH. Consequently, BEREC concludes that the doubts of the Commission regarding the non-recovery of costs of passive infrastructure is the result of a misunderstanding and is thus not justified. BEREC advises NMHH to clarify its interpretation of direct costs in its final decision to avoid this misunderstanding.

BEREC notes that NMHH justifies the non-recovery of common costs by the expected increase of competition based on wholesale leased lines service that are too high priced today, while competition cannot be stimulated by extension of existing infrastructure or entry of a new player.

BEREC understands from NMHH view that the current wholesale prices are too high. These wholesale prices were established in an unregulated market. In general price regulation, which NMHH indeed imposes, should address such a problem. However, NMHH does not explain why MT should provide its competitors leased lines below its own accounting costs. NMHH also does not provide any calculation of the magnitude of the decrease of the

[5] Annex 1, Provisions related to the fee calculation of services prescribed in Points I(D)(2) and I(D)(3) of the operative part of the Decision, paragraph 1.1 Costs to take into account.

wholesale prices that could support this measure. BEREC therefore shares the doubts of the Commission in the way that more evidence is required to justify the exclusion of common costs from the charges.

Concerns of the Commission

As a preliminary point, the Commission takes note of NMHH's practice to annually re-calculate the level of the WACC, and that these decisions have to date not been notified to the Commission. It is not clear at this stage whether interested parties had the opportunity to comment on the WACC calculation method in the context of the national consultation concerning the present notification. Therefore, the Commission reserves the right to further investigate the matter and take appropriate action should it consider that the procedures referred to in Articles 6 and 7 of the Framework Directive have been breached.

The Commission further notes that NMHH calculates the cost of equity applying a mark-up ('size premium') which would reflect the risk of the variability in the return of the operators' shares in the long-run perspective depending on the size of undertakings.

The Commission considers at this stage that such mark-up is not in compliance with Article 8(2)a and 8(5)d of the Framework Directive in conjunction with Articles 13(1) and (2) of the Access Directive for the reasons explained further below.

The weighted average cost of capital is a component of a cost-oriented price to be applied by SMP operators in the market at stake. NRAs are bound, pursuant to Article 8 of the Framework Directive as well as Articles 13(1) and (2) of the Access Directive, to impose a cost control obligation that meets the objectives of encouraging efficient investments, including in next generation networks, and allowing a reasonable rate of return on adequate capital employed, while promoting efficiency and sustainable competition and maximising consumer benefits in terms of choice, price and quality (Article 8 (2)a and 8(5)d of the Framework Directive).

In particular, Article 8(5) d) of the Framework Directive stipulates that NRAs shall promote efficient investment and innovation, whilst ensuring that competition in the market is preserved.

In this respect, the Commission has serious doubts that the level of WACC as applied by NMHH would actually reflect the currently prevailing competitive conditions, in both the relevant and the capital markets in Hungary, taking into account the risk incurred by the investing undertakings. Specifically, the Commission notes that NMHH calculates the cost of equity applying a mark-up ('size premium') which would reflect the risk of the variability in the return of the operators' shares in the long-run perspective depending on the size of undertakings.

Views of NMHH

NMHH is of the opinion that its applied methodology is consistent with the WACC study by the Brattle Group that was ordered by the Commission.

The market risk premium was established on the basis of an international benchmark, having regard to the fact that due to the size of the Hungarian capital market and the low number
of liquid securities, it is hard to observe and quantify the Hungarian market risk premium directly. As the market risk applied is not based on the Hungarian market characteristics and company sizes, NMHH considered it necessary to apply a size risk premium.

In the calculation of the market risk premium applied for the calculation of the cost of capital, NMHH used the companies included in the Duff & Phelps assessment and cost of capital study[6], which are, as regards market capitalisation, characteristically bigger than a typical Hungarian wired telecommunication service provider, thus NMHH deemed it necessary to correct the cost of capital by size risk premiums. An estimation of size risk premiums (SRP) was also carried out based on the ratings published in the study made by Duff & Phelps. The rating was specified on the basis of the market capitalisation of a typical Hungarian telecommunications company - for the large wired group, the wired branch of Magyar Telekom. The "implied theoretical" market capitalisation calculated on the basis of the annual revenue of the wired branch falls within the EUR 798 - 1 322 million range established by Duff & Phelps (1.62 %), from which a 0.8 % mid-range size risk premium, used for the calculation of WACC, is derived.

BEREC's Assessment

The Commission has expressed serious doubts about the application of a size premium in three previous cases.[7] In all the cases BEREC considered those doubts justified. The most elaborate BEREC assessment was done in case SI/2018/2050.[8] BEREC will address the doubts and NMHH's views according to the BEREC Opinion in that case.

About the consistency with the Brattle report BEREC would like to note that the issue of the size premium is not discussed in the 2016 Brattle report. BEREC would also like to mention that the information and views set out in that report are those of the Brattle Group and do not necessarily reflect the official opinion of the Commission. In case SI/2018/2050 BEREC concluded that the report has no legal status.

According to BEREC, the use of a size risk premium is not consistent with the application of the CAPM model, which NMHH says is the model it has used to estimate the cost of equity.

While NMHH argues that MT is relatively small compared to its European telecoms peers, it has not explained why this means it would face higher non-diversifiable risks than those companies would.

As in case SI/2018/2050, BEREC is of the opinion that the use of a size premium in WACC calculations is not commonly applied by NRAs in the EU and the inclusion of a size premium

6 Valuation Handbook – Guide to Cost of Capital (2017)
7 Case SI/2018/2050, SK/2017/2010 and case SK/2018/2051.
8 BEREC Opinion on Phase II investigation in case SI/2018/2050 Market for wholesale high-quality access provided at a fixed location (Market 4) in Slovenia, BoR (18)55, page 6.

in the WACC calculation has not been sufficiently justified by NMHH. Thereby such a mark-up is not in compliance with Article 8(2)a and 8(5)d of the Framework Directive in conjunction with Articles 13(1) and (2) of the Access Directive for the reasons explained above.

BEREC is of the opinion that the Commission's doubts about the application of a size premium are justified.

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 obligations 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 partly justified.

BEREC has the overall opinion that the Commission's serious doubts regarding the under-recovery of costs are partly justified. Although the Commission's doubts regarding the under-recovery of costs of passive infrastructure seems to be based on a misunderstanding, the Commissions doubts regarding the non-recovery of common costs are justified. BEREC advises NMHH to clarify in its final decision what is meant by direct costs to avoid further misunderstanding.

BEREC shares the Commission's doubts regarding the application of a size premium.