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IRG/ERG Response to Public Consultation on Termination Rates

September 2008

Introduction

ERG strongly shares the strategic objective of ensuring cost reflective pricing for fixed and mobile termination rates. We agree that this will enable consumers to continue to enjoy the benefits that result from falling termination charges. We believe such consumer benefits need to be achieved in the context of a predictable regulatory environment which also supports sustainable investment and innovation in the mobile telephony sector. The Commission is proposing a fundamental change of regulatory methodology. It is therefore important to ensure that this change is supported and justified by evidence-based reasoning

In the past four years, mobile termination rates have fallen by almost 40 per cent, under the influence of the glidepaths established by most regulators. These glidepaths will ensure that this downward trend continues. In addition, with an increasingly harmonized approach towards the implementation of cost-orientation by NRAs[1], differences in rates across Europe are also narrowing. Leaving aside outliers, European MTRs now sit in a range between 5.28 cent and 11.63 cent.

Given these positive trends, we believe that there is a strong case for adhering in the short term to established principles of cost calculation. Changes in these principles may also present significant legal risks to those NRAs currently involved in litigation on these matters.

This stance is also consistent with the fact that the current European framework gives NRAs the responsibility to choose and implement appropriate remedies and cost models to deal with the kind of competition problems identified in the Commission’s analysis.
NRAs are strongly committed to the development of the internal market through working closely with each other and the Commission. In our view, this is best achieved by ensuring that national decisions are taken on the basis of shared principles, rather than requiring uniformity in the fine detail of the regulatory approach.

In principle, ERG agrees that it should be the objective of NRAs to have, or be able to refer to, a system of cost based modelling that is reflective of an efficient operator. Also, we would like to stress that ERG is not opposed to the use of a bottom-up/top-down LRIC calculation provided that there is sufficient flexibility in the model to allow appropriate fixed costs, typical in network industries, to be recovered in a reasonable amount of time.

[1] Cf. e.g. the ERG Report on Regulatory Accounting in Practice 2007 (ERG (07) 22), which shows a “*gradually increasing level of harmonisation of the regulatory accounting system in ERG member states*” (p. 26).

In addition, we believe that it would be helpful to include in the Commission's recommendation a best practice approach similar to that adopted in fixed line interconnection (or more recently for leased line prices). As an example, this could involve NRAs matching a weighted average of the five lowest rates as an approximation of an efficient price level, while taking due account of national specifics. In the case of fixed interconnection this setting of "best-practice rates" has been highly successful.

It is difficult to make precise predictions of the outcomes of cost models. However, our experience suggests that significant cost reduction will be achieved by the methods we are advocating. We are confident that if we follow this path, the reduction achieved in the last five years can be broadly replicated in the coming three years. ERG stands ready to work with the Commission so as to monitor this process, establish the right benchmarks and share best practice in developing cost models.

Finally, we believe that we should take the opportunity of the Commission's planned recommendation to set in train a piece of work to consider options for ensuring further progress on regulating interconnection rates in the medium term. ERG believes that now is the right time to study and debate alternative forms of interconnection agreement, such as "bill and keep".

Part 1: General comments

Comments on reasoning used to support Commission's preferred approach

One of the central features of the Commission's reasoning is that call termination is a service that generates benefits to both calling and called ('receiving') parties[2]. This in turn suggests that both parties should share the costs of termination. The Commission then concludes that these features of the market justify a specific cost-based methodology to setting termination rates. This is a long-run incremental cost (LRIC) approach, where the relevant increment is defined to be the wholesale call termination service. Only those costs that would be avoided if the termination service were no longer provided should be included in the termination rate.[3] The Commission's endorsement of a pure LRIC approach appears to imply that the resulting termination rate levels would represent a reasonable sharing of the costs of termination between calling and called parties.

The ERG believes that the existence of receiving party benefits may justify cost-sharing, but does not point to any particular level of cost sharing or to a particular method for setting the level of regulated MTRs. In this regard, the ERG stresses that economic theory does not imply that there is a uniquely correct way of allocating shared costs between the calling and receiving party. In fact, there are various valid ways of sharing costs, which may result in materially different termination rates.

Also, ERG likes to stress that it is not opposed to the use of a bottom-up LRIC calculation provided that there is flexibility into the model also to allow appropriate fixed costs, typical for the network industries, to be recovered in a reasonable amount of time.

In light of the above the ERG asks the Commission to consider opening to alternatives and to assess such alternatives against a set of criteria - incorporating both economic and 'good practice' regulatory principles[4] - which could be recommended to NRAs. These criteria could include those set out in Table 1 below, and these criteria could also be applied to other approaches such as Bill and Keep.

[2] This feature of the termination service is often referred to in the academic literature as a 'call externality'.
[3] The Commission's reasoning is set out in Recital 13 of the draft Recommendation. Throughout this note, we refer to the Commission's approach as a 'pure LRIC' approach.
[4] 'Good practice' regulation does not mandate or encourage any particular substantive outcome, but refers to regulation that is transparent and accountable, which reduces the regulatory burden on market participants and which reduces unnecessary bureaucracy.

Table 1: Criteria for assessing different approaches to TR regulation

Allocative efficiency	o Does the proposed approach sets rates close to marginal costs? o Does the proposed approach reflect principles of economically efficient pricing i.e. does the proposed approach take account of receiving party benefits?
Cost recovery	o Does the proposed approach enable the operator to recover its (efficient) costs?
Symmetry	o Does the proposed approach lead to symmetric termination rates in a reasonable time period?
Competition	o Does the proposed approach hinder competition both between mobile operators, and between fixed and mobile operators as well as between fixed operators?
Consumer benefits	o Does the proposed approach benefit consumers?
Promotion of efficient investment (i.e. productive and dynamic efficiency)	o Does the proposed approach promote or hinder efficient investment, and is it well suited towards an NGN environment?
Consistency across Member States	o Does the proposed approach result in similar termination rates across Member States given the inherent national market differences?
Ease of implementation/ regulatory burden	o Can an NRA implement the proposed approach with relative ease? How do the direct and indirect costs of this form of regulation compare with alternative approaches? o How much certainty does the proposed regime provide to all market participants?

The ERG believes the pure LRIC approach, as proposed in the draft Recommendation, might perform well against some of these criteria. For example, the pure LRIC approach is likely to perform well against the allocative efficiency criterion and is also likely to lead to the absolute level of termination rates falling across Member States (although relative differences will remain and may in fact increase). It is less clear whether it performs well against the cost recovery criterion.

In addition the ERG believes that a best practice approach, similar to the highly successful benchmark adopted in the fixed line interconnection, can be introduced as a possible alternative methodology aimed at gradually reducing termination rates over the next 3 years to a target level. This may consist in reaching the 5^{th} lowest termination service rate or a value equal to the weighted average of the five lowest rates as an approximation of an efficient price level.

Comments on the use of alternative methods

It is important to note that allowing some NRAs to pursue their own approach may in fact result in lower TRs, as against a situation where these members are forced to pursue a pure LRIC approach. It may be, for example, that TRs based on top-down fully distributed costs produce relatively low rates. Currently, the UK FTRs and Finnish MTRs are both amongst the lowest in Europe despite being based on a top-down fully attributed costing approach. The use of actual cost data combined with published regulatory accounting information also has a significantly beneficial effect in promoting transparency and confidence with stakeholders, placing a clear burden of proof on the operator and reducing the incentives to challenge regulatory pricing decisions.

ERG notes that the draft recommendation provides for the possibility of NRAs applying alternative approaches but subject to important qualifiers. Alternative approaches will only be acceptable for an interim period of 2 years[5] but only where an NRA is not in a position to finalise the recommended cost model and where the NRA can demonstrate that the alternative will result in outcomes consistent with the recommendation. A further limiting condition is that the interim rate should not exceed the average of the rates set by NRAs who have implemented the pure LRIC approach in the recommendation.

[5] Article 11, draft Commission Recommendation

Part 2 Remarks on specific parts of the of draft Recommendation

***Remarks on Recitals* (*2*) *and* (*3*)**

The ERG observes that Recital 2 as well as Recital 3 contains two different arguments which should be better split.

Recital 2: ERG questions the statement that "*In addition to a significant variety in the chosen costing tools, there are also different practices in implementing those tools. This widens the spread between wholesale termination rates applied across the European Union, which can only be partly explained by national specificities.*.". The ERG CP on symmetry of FTRs and symmetry of MTRs (ERG (07) 83) states that "*as a conclusion, it can be said that the regulation of market 16 is homogeneous for the definition and the remedies imposed*" (p. 67). The ERG Regulatory Accounting Report 2007 (ERG (07) 22) also notes a narrowing of the different costing methods used (p. 12/13 and p. 16/17)[6], the application of which might differ (cf. ERG Common Position on symmetry of FTRs and symmetry of MTRs (ERG (07) 83), pp. 67). However, differences in rates are not solely attributable to the different application of costing methods, but are also explained by national specificities. Different national specificities lead to differences in rates across Europe, even if the same costing methods are used.

Regarding the statement on asymmetry at the end of Recital 2, ERG has clearly stated in its Common Position on symmetry of FTRs and symmetry of MTRs (ERG (07) 83) that termination rates should normally be symmetric and that asymmetry, acceptable in some cases, requires an adequate justification" (p. 82). Asymmetries within countries should decrease as NRAs follows the CP. ERG invites the Commission to rethink the necessity of dealing with symmetry of TR in the draft Recommendation as it has already been subject to extensive analysis in ERG recent Common Positions. If the Commission does wish to deal with these issues, the ERG urges it to not adopt a position which could be seen as being inconsistent with that contained in ERG documents. In particular, the Common Position contains guidance on the circumstances in which asymmetric termination rates may be justified temporarily. Some of the Commission's statements on these issues could be viewed as potentially conflicting with these general principles and earlier Commission policy statements.

Recital 3: The statement of "*significant divergences in the regulatory treatment of FTRs and MTRs*" is open to question as it depends on the categorization of the radio access

[6] Therefore, the ERG believes that the reference to the Regulatory Accounting Report in Footnote 28 of the Explanatory Memorandum to prove that "*important differences between MS in the implementation of cost orientation are observable*" (p. 11) is incorrect. The report shows a "*gradually increasing level of harmonisation of the regulatory accounting system in ERG member states*" (p. 26) – in fact the opposite statement.

network. Saying that there is a different treatment implies a clear position on the treatment of coverage costs in mobile networks. Given that mobile coverage costs are not driven by traffic levels or the number of subscribers on a network, it is not clear that the allocation of these costs can be determined by reference to cost causality. The Commission's underlying position on coverage costs should be spelt out clearly in order to avoid creating a picture which is certainly not true in its generality.

Finally, the last sentence of the recital affirms that high termination rates tend to lead to high retail prices for originating calls, but this is not necessarily the case. Such negative effect may be compensated in case operators exploit their monopoly power in call termination to subsidize subscriber acquisition costs (so called "waterbed effect").

***Remarks on Recital* (*8*)**

In the last sentence of Recital (8), the ERG recommends the addition of the word "forever" so that it becomes "*New entrants* [……..] *should not rely forever on receiving higher termination rates upon market entry*". The ERG CP states that there are some situations where asymmetries may be justified in certain specific situations. In particular, asymmetry may be justified: on a transitory basis: for a late entrant to take into account its lower economies of scale; where there are exogenous cost differences between operators and in certain cases before MTRs are at a cost level. These issues are discussed at length in the CP on symmetry, and the ERG believes that the draft Recommendation should not re-open these issues.

Remarks on Recitals (9), (10) and (11) and on the corresponding Recommendation's Articles 2 and 3 as well as the corresponding parts of the Explanatory Memorandum

Recitals 9 and 10 make statements on three related issues: current costs, efficient operator and modern technology. The ERG agrees that the best approximation of a competitive outcome (cf. comments to Recital 4) is to set rates at the level of the cost of an efficient operator employing modern technology on the basis of current costs. However this does not necessarily imply using a bottom-up model. A bottom-up model facilitates the construction of an efficient network and reflects the equipment quantity needed, but this should be distinguished from the use of current costs which refers to the valuation (cost base) rather than the quantity. There are various costing tools that allow calculating the cost of an efficient operator employing modern technology on the basis of current costs. In fact, the success of the outcome depends on the details of the model and the accuracy of data inputs. There is no reason a Top Down (TD) model is inefficient as efficiency adjustments can be performed in TD models as well. Therefore, the ERG is of the opinion that the Recommendation should not favour one costing tool over the other, but confine itself to recommending the mentioned principles. In case the Recommendation will favour a specific tool (such as a bottom-up model), this implies that NRAs should not have a burden of proof when they use other costing tools (see also Recital 20 and Art. 11). Furthermore, the draft Recommendation says a lot about the strengths of a BU model but fails to recognise its weaknesses (information asymmetry, expensive, easy to miss costs etc). The use of TD models is more popular reflecting the strengths of using actual data. Most experts recognise both methods used together (or reconciled) produce the most defensible and robust result.

In conclusion, the ERG considers it important to emphasize in this paragraph that whatever the particular choice of model (TD, BU, hybrid) is used to measure efficiency, the same measure should apply to both MTR and FTR.

Recital 11 (and Art. 3): the ERG agrees with the statement that the choice of the efficient technology should be available in the timeframe considered. The ERG also agrees that in principle the core network should generally be considered to be NGN, although some members have reservations about this issue, on the basis that no operator has already migrated to a full NGN network and that correspondingly obtaining reliable cost accounting data on NGNs is likely to be a problem in the near future.

Regarding the statement prescribing the use of a bottom-up model as the only costing tool, see comments to Recital 10. The ERG wishes to draw the Commission's attention to the following: the statement in Art. 3 that "*efficient technologies must be available in the timeframe considered*" could cause a problem unless it is implied that this means that "efficient technologies must be available on a large scale in Europe", as otherwise price increases of equipment vendors could lead to an increase in rates rather than a decrease when the same technology is included in the regulatory cost calculations across Europe at the same time.

Remarks on Recital (20) and Article 11

The ERG believes that a bottom-up LRIC model is only one of the various methodologies that may be used to obtain an efficient outcome. Moreover, bottom up and top down models are not always strict alternatives. More generally, the ERG notes that the Recital accepts that alternative methodologies can result in outcomes consistent with those in a competitive market. The ERG strongly agrees with this conclusion. In ERG's view this conclusion should enable NRAs to consider other methodologies such as Bill and Keep and Reciprocity.

For this reason the ERG considers that Article 11 of the draft Recommendation should recognise that NRAs may use alternative methodologies where appropriate. ERG believes that benchmarking, particularly in the context of small markets or small operators, constitutes a more relevant and proportionate mode of regulation. Use of such alternative methodologies should not be subject to an unreasonable time limitation.

Remarks on Chapter 6.1 of the Explanatory Memorandum

- Chapter 6.1. "Possible alternative approaches" blurs the difference between wholesale (CPNP/B&K) and retail (CPP/RPP) mechanisms. Both (wholesale and retail) are closely related, nevertheless, CPNP and B&K provide flexibility with regard to the retail pricing regime.

- Although it is correct to state that "RPP may evolve after a reduction of the regulated termination charge or as a response to a B&K system" (last para. of 6.1.4), it is important that B&K does not necessarily lead to RPP on the retail level as B&K is currently observed to be associated with every tarification scheme. In practice, the observable trend towards flat-rate or ‘bucket’ retail schemes may be even more important and such schemes are offered in countries that currently operate under a B&K (or similar). End-users are familiar with flat-rate schemes as they are widely applied for Internet access.

- While it is true that B&K has generally resulted from voluntary agreement between interested parties, it is also the case that B&K could be mandated as part of a regulated solution. These comments do not purport to provide a legal opinion on this issue, but merely to point out that the Commission should not at this stage rule out the possibility of B&K being mandated by NRAs.

- Section 6.1.3 points out that "a net recipient of traffic would likely prefer a higher termination rate and vice versa". Although this seems plausible it is important to note, that the concept of B&K - different from peering arrangements - does not require symmetry of traffic flows to be applicable.