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TELEFONICA comments with regard to BEREC BoR (14) 123

Public Consultation on

Draft BEREC Guidance on the regulatory accounting approach to the economic replicability test (i.e. ex-ante/sector specific margin squeeze tests)

24 October 2014

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1. Introduction

Telefónica S.A. (hereinafter Telefónica) welcomes the opportunity to participate in this consultation on the Draft review of the BEREC Guidance on the regulatory accounting approach to the Economic Replicability Test (ERT hereinafter).

Telefónica believes that, being the NGA deployment one of the core objectives of the Digital Agenda for Europe, a basic question would be to clearly delimit the role that the ERT can play in this context. In particular, Telefónica considers that, while the ERT is a tool that can be useful to analyze scenarios of service-based competition, its application is not appropriate when competition is based on independent infrastructures. The existence of alternative independent platforms makes access to traditional incumbent operator networks an input no longer necessary. Moreover, the ERT fails to take into account the risks assumed by investors.

In any case, if an NRA finally decides to apply the ERT, the parameters used should reflect as closely as possible the new competitive framework generated with the development of NGAs. Special attention should be paid to pricing flexibility for investors and the careful assessment of the structures and specificities of the markets in question. In this regard, Telefónica would like to make a number of observations on the methodological aspects included in the document.

Considering the above, in what follows Telefónica would like to submit its views about the different issues contained in the draft Guidance document, in the hope that they will be acceptable to BEREC.

2. General Comments

Telefónica considers necessary to address two general issues that are crucial for the ERT implementation. These are related to the scope of its application and the way that the risk sharing should be handled.

1. The test should not be applied when competition is based on independent networks.

In Telefónica's view, prior to the application of any margin squeeze test or ERT, the need for price regulation (or regulation as a whole) should always firstly be assessed, considering the state of the art of competition. Independent networks presence and lack of barriers to entry should be properly acknowledged to allow for full deregulation in competitive areas.

From the point of view of Telefónica, the rationale for the application of the test appears to be based on a scenario where alternative operators must resort to the services of the SMP operator to develop their NGAs but fails to account for the scenarios where fully independent networks are being developed.

It should be taken into account that independent fiber infrastructures do not use, or use far less, wholesale access services provided by the incumbent operator's network. This is a totally different situation that the one applying for current copper networks, where there are not alternative independent networks as it occurs in the case of fiber.

Given the above, it seems clear that, in this scenario of independent networks, it is meaningless for competition to apply the ERT test, as the incumbent operator wholesale prices have no impact in the commercial offer of alternative operators (the incumbent could raise or lower wholesale prices without consequences for competitors as they do not really need to resort to the incumbent wholesale offer). On the contrary, its application is counterproductive as it drastically conditions the capacity of the incumbent operator to innovate and launch new products to the market, which ultimately is detrimental to customers and social welfare.

Moreover, it should be noted that the European Commission, in its revised recommendation of relevant markets (published last October 9, 2014) , has removed all the remaining obligations on the retail markets, considering that they are no longer necessary. The ERT should not end up constituting an alternative way to retrieve such regulation.

Finally, it is also worth noting that our current regulation seems to rest on the assumption that the only competitive tool is price reduction. Regulators should consider that, particularly in a context where independent networks are in operation, there are many more competitive strategies, which may be based on aspects such as the quality of the service, customer care, differentiated commercial offers, etc.

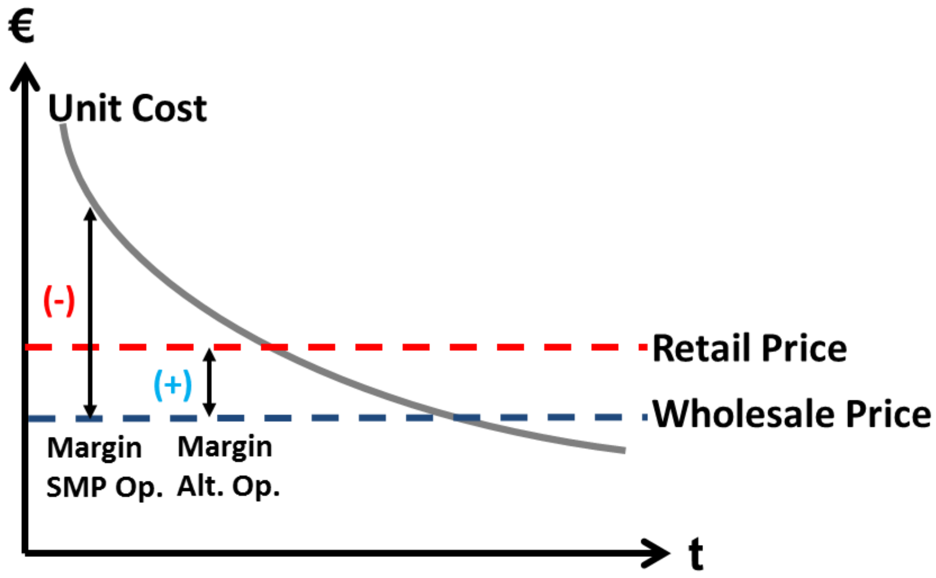
In conclusion: **When NGAs deployments are based on independent FTTH roll-outs, regulators, taking into account the different competitive conditions prevailing in each geography, should assess whether price regulation, and consequently the application of the ERT, is appropriate or not.**

2. The common assumptions used in the traditional margin squeeze tests fail to take into account the risk taken by the NGA investors

The deployment of new fiber networks requires high upfront investments with long and uncertain payback periods. This makes the classic margin squeeze methodologies inadequate.

The main problem with the application of the ERT lies in the asymmetry of the risk allocation between the access seeker (who assumes no risk) and the investor operator (who assumes a high risk). The provision of individual wholesale services without any kind of commitment on permanence or volume determines an absolutely asymmetric regime, where the operator requesting access for a given price has a positive return for each client from the initial stage, while for the investor operator, with the same price, profitability will come only when the cash flows can ensure the return on investment, provided that the assumptions of its business plan (cost reduction, economies of scale, take-up, etc.) are met. Any deviation from those hypotheses decreases the investor returns, while it does not affect the access seeker.

This situation is depicted in the following chart.



It would be meaningless to incorporate the concept of risk assumption in the wholesale price if it is not taken into account later when applying the ERT. If this issue is not properly addressed, competitive market conditions could be seriously distorted, to the detriment of investors. This is a very unfair situation and could end up seriously undermining investment.

In short: If the result of the test is that the access seeker´s profitability is guaranteed over the average customer lifetime while the investor operator could have a negative outcome, the ERT application would be clearly counterproductive and should be rejected.

Since this is a fundamental issue, Telefónica considers that the Guidance document should include a specific chapter on how to address it. Several ways to approach the problem have been identified:

- **DCF calculated on the infrastructure lifetime:**
Under this approach downstream costs would be discounted on customer lifetime while upstream costs would be discounted on infrastructure lifetime

- **DCF calculated on the customer lifetime but with a modified cost base:**
Under this approach only variable wholesale costs calculated at LRIC+ should be included in the ERT

3. Specific Comments to the Methodological Questions

In the Guidance document, BEREC proceeds to the analysis of the methodological questions that must be answered when implementing the ERT. These questions can be grouped into five main areas, namely:

- Objectives of the test (including the level of efficiency)
- Cost standard
- Time period
- Retail products
- Geographical Segmentation

For each area is addressed:

- The provisions included in the Commission's Recommendation (Chapter 2),
- The NRA´s current practice (Chapter 3)
- The alignment of the current practice of ex-ante margin squeeze tests as applied by NRAs and the main characteristics of the recommended ERT (Chapter 4).

Following the same scheme, Telefónica would like to draw the BEREC´s attention on a number of issues that will be addressed in the following points.

Additionally, and in accordance with the foregoing, **Telefónica considers that the Guidance document should include an additional chapter to deal with the issue of risk sharing between investor operators and access seekers,** in such a way that the ERT also incorporates hypothesis of risk assumption by the access seeker. Profitability reached by the access seeker should be positive or negative depending on whether or not a number of goals are reached, as in the case of the investor operator.

3.1. Objectives of the test / Level of efficiency of the operator

Firstly, Telefónica would like to point out the fact that, when addressing the primary objective of the ERT (in point 4.1., pages 29 and 30) it is recognized in the considerations that its purpose is to have a safeguard for competition, allow efficient market entry and promote efficient investment in NGA networks. Nevertheless, in the final draft conclusion it is only stated that:

> *The primary objective of the ex-ante economic replicability test is to safeguard competition in cases where no other cost-oriented price regulation pursuant to Art. 13 Directive 2002/19/EC is imposed. Moreover, the ERT is used to ensure non-discrimination and transparency, pre-venting exclusion from the market.*
>
> (Emphasis included in the original text)

In this draft conclusion the focus is only put on the goal of preserving competition and the equally important goals related to investment and efficient market entry are left aside. Telefónica believes that these goals should also be incorporated.

Regarding the issue of the level of efficiency of the operator, Telefónica considers that **the EEO test is the one that should be used** when competitive independent platforms are already in place or in trend of developing, as it is the one that better grasp the reality of the market. To this respect Telefónica shares the arguments for EEO already listed in pages 18 and 19 of the document.

In particular, it is important to stress that the EEO test:

- Prevents the risk of inefficient entry, which could be very harmful for investment. In this respect, Telefónica considers that “competition´s protection” should not be confused with “competitor’s protection”. In the current situation priority should not be given to grant the entry of other competitors at the expense of the possibility to transfer efficiencies to the end customers. That would be contrary to the ultimate purpose of regulation, which is to benefit customers. It would neither meet the recommendation goal of granting an appropriate balance between efficient entry and incentive to invest.

- Meets the non-discrimination principle.

- Minimizes the possibility to impose on the SMP operator unreasonable burdens.

- It does not need to rely on complex assessments of the economies of scale of an efficient operator or questionable calculations or guesses about the adjustments to be applied to EEO that could lead to false positives.

- It is the approach that better reconcile the ex-ante and ex-post analysis.

- It leads to the lowest retail prices for end users.

- Provides legal certainty.

Finally, Telefónica considers that EEO characterization should include risk assumption by the access seeker.

3.2. Cost Standard

Regarding this issue Telefónica would like to make the following comments:

- **Model:** Telefónica agrees that a **LRIC+** model could be a reasonable approach, to calculate the cost of providing the downstream service, depending on the mark-up added to account for common costs. However, if the NRA has used a pure LRIC model to price regulated services, the ERT cost model should be consistent with this and therefore use the LRIC standard for the assessment of all costs.

- **Depreciation Method:** Telefónica considers that the **straight line** approach is appropriate.

- **Reasonable Profit:** Telefónica considers that the **WACC** approach is appropriate.

- **Average User:** Telefónica considers that the **average end-user consumption profile** approach should be taken, as it is the one that reflects the reality of the market. This is consistent with the fact that operators develop their products on the basis of user consumption, not nominal offers. Otherwise flat rate products would probably never have been launched.

  In any case, the average end-user consumption profile used should be the one corresponding to the SMP operator. This is a necessary requirement because the replicability test will have to be conducted on the SMP operator offer, in accordance with its clients demand. The use of a different demand could impact on the replicability without any possibility of control by the SMP operator.

- **Wholesale Input: The reference regulated wholesale service considered for the test must be the one used by the most efficient operator.** In this regard, an efficient operator will always use the lowest available level. It means that, whenever it is feasible, this service should be the access to the SMP operator civil infrastructure (i.e. ducts). Otherwise, we would be allowing for inefficient operators, forcing up the price of the SMP operator and, at the same time, allowing other operators that deploy their own fiber to set prices below the reference price resulting from the test applied to the SMP operator.

In any case, **the Wholesale services to be considered should be those that are really being offered in the market**, not hypothetical services that could be offered. Moreover, the existence of other complementary regulated or commercial wholesale services should not condition the test, particularly when they are scarcely used, otherwise a replicable price under the paradigm of infrastructure competition, could result in a "false positive" under a competition in services scheme.

- **Non-regulated input costs:** The scope of those inputs is not clearly delineated in the Guidance document. If this refers to the international internet connectivity costs the carrier market provides lower costs and should be preferred.

3.3. Time Period

Telefónica considers that, following the Recommendation approach, **profitability analysis should be conducted based on the following terms:**

- **Using a dynamic multi-period analysis, such as the discounted cash flow (DCF) approach,** as foreseen in the recommendation. Taking into account the huge investments required, this is the best way to guarantee that one-off costs are properly spread over a reasonable calculation period and avoid false results of the test (short/medium term losses should not be regarded as exclusionary tactics but as a natural outcome of the kind of investments required on NGAs). At the same time it can properly encompass the incomes / cost potential evolution[1].

- **Considering a plurality of time periods**. Thus reflecting the radically different nature of the different investments to be carried out. For the infrastructure investments the most adequate period would be the infrastructure lifetime. For the investments in customer equipment and commercial costs the customer lifetime. For the costs associated to new services (i.e. IPTV) either an implicit cost test or a customer life time could be appropriate. This is the real way in which operators analyze the overall profitability of the business projects over its entire life on a forward-looking basis

  Telefónica considers that this principle is in fact proposed in the following paragraph (page 35) where it is recognized that the relevant period for consumer downstream costs is the customer lifetime while for infrastructure costs is the infrastructure lifetime:

  > *In relation to the period over which to depreciate investment costs, a relevant consideration is the type of investment costs that are being depreciated. For customer related investment costs (e.g. marketing, connection, customer retention), they should be recovered over a period of time, reflecting the period over which a new (or retained) customer can be expected to generate positive cash flows for the operator. That is, these costs should be spread evenly over the expected average customer lifetime. For non-customer related investment costs (e.g. physical equipment), the useful economic life of the asset in question is likely to be an appropriate period over which to spread costs.*

On the other hand, in the context of fully independent FTTH networks, when dealing with the question of the **fiber customer average life**, it should be taken into account the following:

- **The value used should be the highest possible in the market.** This is the most consistent with an EEO test, which in Telefónica's opinion is the one that better fits in this kind of scenario.

1 In this context Telefónica would like to take the opportunity to stress the importance of removing all possible barriers to investment. A relevant issue is to facilitate the legacy copper switch-off, in order not to damage the fiber business case. Strict requirements to maintain copper could imply that operators should have to spend additional OPEX to maintain two networks.

- Telefónica disagree with the proposal to use the average customer lifetime of copper broadband products. Experience shows that NGA products have lower churn rates and that should result in a higher lifetime value. In fact, **average customer lifetime of fiber products almost doubles the ones of copper broadband.** Anyway, if required to make a comparison, conceptually it should be with the average life of the copper line (the whole access) and not with that of the broadband products offered on the copper line. This taking into account that, in the context of NGAs, fiber constitutes the new access.

3.4. Retail Products

Regarding this issue Telefónica wishes to make the following comments:

- **Level of Aggregation:** In a situation where competition takes place on the basis of the set of services offered by operators, Telefónica considers that the **analysis should be performed on a whole Portfolio of services, with the highest level of aggregation**, instead of a product by product approach. That because:

  - It allows more flexibility for the incumbent to innovate and launch new services to the market. It also gives maximum scope for product differentiation. As a result of that society wealth is maximized.
  - Alternative infrastructure operators will base their investment decisions on their entire product portfolio, not on individual products. So the principle of non-discrimination is better met.
  - Reflects better the dynamics of the whole market, which is where the operators compete.
  - Respects the multi-service nature of the NGA.

- **Bundles:** Telefónica believes that, in principle, all the services additional to access should not be incorporated to the test. Anyway, when included in the ERT, **enough flexibility should be given to accommodate products requiring investments whose return is not achievable in one year**. That is, for example, the case of the contents included in the IPTV services, whose acquisition involves substantial upfront fixed costs. In such cases, operators could base their business plans on the expectation of recovering the investment through the progressive increase in the number of users during several years.

3.5. Geographic Segmentation

Telefónica welcomes the positive approach to geographic segmentation contained in the Guidance document and wishes to reiterate its view on this issue. It can be summarized, for the purposes of this document, as follows:

Competitive situations can be very different and, consequently, should be differently addressed. Geographic segmentation provides a powerful tool to do that.

- In the case of NGA deployment, where there is competition, once essential facilities (as ducts) are opened and are being used by alternative players for **FTTH deployment** (in combination with symmetric obligations such as in building wiring), no other obligation should be imposed, as all operators are able to undertake investments in new generation networks on equal terms, having the possibility to build fully independent networks. In this situation **ERT should not be imposed.** If, despite of this, the test is applied, the reference wholesale service should be the access to the SMP operator civil infrastructure (i.e. ducts).
- When network deployment is based on **FTTN**, copper remains a barrier to entry, so some sort of regulation of passive and active products would remain necessary. In this case is where **ERT can play a relevant role.**

4. Transparency issues

In this section, Telefónica believes **essential that the ERT does not impose such a rigid monitoring that conditions the SMP operator's retail offer to the point of distorting the market**. The ERT´s aim should be to prevent the SMP operator to have a competitive advantage over other alternative operators and not to provide other alternative operators with a competitive advantage over the SMP operator (the non-discrimination principle should be regarded from both sides). In this sense, it is possible to highlight the following issues:

- **The SMP operator should never be required to wait until the NRA verifies the compliance with the ERT before launching a new retail product.** Time to market is an essential tool in the current state of the art. This kind of obligation would impose an unfair and unreasonable burden on the capacity of the SMP operator to compete.

- **Commercial secrecy should always be preserved. The ERT should never constitute a tool for other operators to gain knowledge of the SMP operator commercial plans and strategies**.

- **In Telefónica´s opinion the test should not be launched following an event-trigger approach but conducted periodically once a year.** The period basis is consistent with the portfolio approach and the annual cycle can be justified by the fact that it is not possible to gather consolidated data for shorter periods and the results would not be stable.

Telefónica would also like to take the opportunity to raise a very important issue: **Transparency should not only work in the direction SMP->NRA but also in the direction NRA->SMP operator**. This means that **the NRA should provide the SMP Operator with the relevant information (procedures and data) about how the test is going to be performed,** so that the SMP Operator can simulate internally the test, otherwise the SMP operator could be in a situation of legal helplessness.

5. Margin squeeze in the context of competition law and differences with the ex-ante approach

Experience shows that there are great uncertainties generated by the different ex ante (sectorial) and ex post (competition) analysis. Telefónica has severely suffered such different treatment (Case COMP/38.784-Wanadoo España vs. Telefónica). Taking that into account, **Telefónica believes that it is necessary a unique test that reconciles both sides and brings greater legal certainty in compliance with both regulations**.

In the Guidance document it is stated that, although the ERT is specifically created for the ex-ante purposes intended with the Recommendation, it builds upon the concepts used in the margin squeeze test used in ex-post competition law. Nevertheless, at the same time, an entire chapter (6) is devoted to highlight the differences between ERT and margin squeeze tests used by competition authorities.

In view of this, Telefónica wonders if the ERT implies some advance in the goal of unifying both points of view or, on the contrary, does not imply any progress in this regard.