BoR PC05 (14) 08

Vodafone's response to

BEREC Guidance on the regulatory accounting approach to the economic replicability test

(i.e. ex-ante/sector specific margin squeeze tests)[1]

24 October 2014

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Introduction

Vodafone welcomes the opportunity to express its views on BEREC's guidance document on "the regulatory accounting approach to the economic replicability test (i.e. ex-ante/sector specific margin squeeze tests".

The Digital Agenda for Europe sets ambitious targets for high speed broadband. The achievement of those targets requires a robust and supporting regulatory framework conducive to investment in infrastructure and effective competition along the value chain. [2]

An essential instrument of the regulatory framework is the "Commission Recommendation on consistent non-discrimination obligations and costing methodologies to promote competition and enhance the broadband investment environment" (the 'Recommendation') and in particular the economic replicability test (the 'ERT') which if properly designed and implemented will contribute to safeguarding upstream and downstream competition in NGA product markets.

The overarching purpose of the ERT is to ensure that retail offers of the incumbent can be replicated by alternative operators of a reasonable scale. Safeguarding downstream competition is a central objective of the ERT together with providing investment incentives. However, as per the Recommendation, the ERT applies solely where the NGA wholesale inputs are offered on an EOI basis. Where this is not the case, NRAs should apply appropriate remedies such as cost based access pricing and a no margin squeeze obligation.

Considering the complexity of the evolving NGA environment, Vodafone fully supports BEREC's notion that the "ERT needs to be applied intelligently and its parameters calibrated accordingly"[3]. Indeed, the extent to which the ERT achieves its objectives depends crucially on the detailed design of the test, the parameters used and the implementation of the test. Further, a robust compliance and monitoring framework is essential.

[2] Commission Recommendation on consistent non-discrimination obligations and costing methodologies to promote com-petition and enhance the broadband investment environment (C(2013)5761 final), 11/09/2013, OJ L 251 of 21/09/13
[3] See: BoR (14) 123, p. 6.

Vodafone recommendations

Considering the complexity of the underlying components of the ERT, Vodafone fully supports BEREC's initiative to provide guidance on how to implement the ERT set out in the Recommendation.

Overall, Vodafone agrees with the following propositions in the BEREC guidance document:

- The adoption of LRIC+ as the appropriate cost standard;
- An adjusted EEO approach;
- A depreciation method suitable to the asset class considered; and
- The adoption of a multi-period DCF method *in conjunction* with a period-by period analysis to take full account of the issues outlined by BEREC

Beyond these, Vodafone believes that there are a number of areas that warrant further consideration in order to ensure that the general principles set out in BEREC's guidance document to assist NRAs in designing meaningful ERT at national levels which effectively safeguard competition.

- Firmer guidance and position on best practices: While it is important to leave some room for detailed implementation at national levels, there are areas (e.g. on transparency) where BEREC should provide a firmer guidance and indication of what it considers as best practice to ensure consistency across Member States in the implementation of the ERT.
- Applicability of the ERT: BEREC should clearly outline the limited conditions under which the ERT applies as per Recital 52 and Articles 48 and 49 of the Recommendation. Where the ERT does not apply, NRAs should impose appropriate remedies, including cost based access and margin squeeze tests.
- Relevant profit measure: In line with its position on the adjusted EEO approach, Vodafone advises that consideration should be given to adjusting the WACC of the SMP operator to better reflect the WACC of a suitably defined hypothetical challenger.
- Relevant costs, revenues and allocation: All relevant costs, revenues and promotions need to be adequately captured in the test and apportioned in line with cost causation principles.
- Wholesale inputs and costs: Vodafone submits that the ERT should be based on the most appropriate active NGA wholesale input offered on an EOI basis used to replicate the downstream service. Consistent with the EC recommendation

Vodafone further supports that "NRAs should give due weight to the presence of volume discounts and/or long-term access pricing agreements between the SMP operator and access seekers".[4]

- Retail products: The definition of flagship products in the EC recommendation warrants further clarification in BEREC's guidance document. Considering that the NGA market is constantly evolving and in light of the risk of anti-competitive behaviour, Vodafone proposes to include all new and existing flagship offers on the basis of a materiality threshold and a set of criteria to justify the conduct of an ERT.
- Promotions and discounts: Promotions and temporary discounts in their various forms (such as vouchers, free equipment) need to be taken into account when performing the test. It is improper to solely focus on the head line price.
- Level of aggregation: In order to include sufficient safeguards against anti-competitive behaviour a flagship product by flagship product approach should be used.
- Consideration of bundles: all revenues and costs of all the services in the bundle should be taken account of. Further, the test must be designed in a way to account for emerging quad play offers and innovation in the market.
- Business offers (SOHO): the scope of the ERT should include retail offers for SOHO based on the relevant wholesale NGA product.
- Pre-notification and compliance: An effective system of checks and balances is pivotal in order to limit gaming opportunities and ensure that the SMP operator is not pricing its services in a way that prevent economic replicability by its competitors. This includes a transparent pre-notification system before the launch of new products as well as a regular tests based on actual data to verify ex ante forecasts and assumptions made. Where a squeeze is identified it should be immediately remedied.
- Transparency: The model used should be made available to any interested party subject to confidential information. There should be a high level of transparency of the information used.
- Cost information: While Vodafone is cognisant of the constraints of commercially sensitive information, Vodafone considers that the cost submissions of incumbent and other information impacting results should be subject to third party audits in conjunction with cost accounting obligations as appropriate regulatory measures. Practically this would mean requiring the populated model used by the incumbent operator to be audited.

[4] OJ L 251, 21.9.2013, p. 28.

General points

At the outset of its response, Vodafone would like to raise some general points which are important to bear in mind with respect to the conduct of the ERT.

Firstly, Vodafone agrees with BEREC that as per the Recommendation, the ERT applies when a specific set of cumulative conditions, such as NGA wholesale input provided on an EOI basis and retail price constraint, as set out in Recital 52 and Articles 48 and 49 of the Recommendation, are met. Where this is not the case, NRAs should impose appropriate remedies such as cost based price controls and appropriately define ex ante margin squeeze tests taking into account the national situations.

Secondly, it is important to recognise the rapidly changing environment of the NGA market. To this end any proposed ERT methodology must be flexible enough to accommodate changes within the product space, most importantly at the retail level but also in terms of the product composition, potentially viable flagship offerings and wholesale inputs. Therefore the model used should be amended when and as required.

All relevant costs must be captured at both the wholesale and retail level.

NRAs should conduct a comprehensive consultation of the proposed ERT at the national level. The consultation should cover all the relevant aspects, including level of aggregation, model to be used, and procedures for the ex-ante test. The model, with commercially sensitive information redacted should be consulted upon and the final version made available to interested parties.

Beyond these general points Vodafone would like to comment on various dimensions of the ERT.

Applicable levels of efficiency

While the Recommendation makes it plain that the downstream costs should be estimated based on the costs of the SMP operator, i.e. use the EEO test, it explains that adjustments may be justified to ensure that economic replicability is a realistic prospect.

Vodafone supports the use of an adjusted EEO test to address inherited incumbent advantages and significant scale differences balancing the trade-off between productive efficiency and dynamic efficiency.

Reasonable adjustment should be made with cost drivers such as average customer lifetimes, bandwidth costs, out of bundle calls, and TV content costs. Further where an access seeker must incur additional costs (e.g. collocation) to make use of the wholesale services those should be taken into account.

Relevant cost standard

Vodafone supports the use of the LRIC+ cost standard for the ERT to calculate the incremental cost of downstream activities, including a return on capital employed and a reasonable mark-up for common costs, as provided in the Recommendation.

However there are instances, such as for certain retail cost categories, where the use of FAC (subject to adjustments that may be required) may be a reasonable proxy for LRIC+, including where cost accounting information in accordance with LRIC+ is not available .

Depreciation method

A depreciation method suitable to the asset to be depreciated should be used. For network equipment, a tilted annuity is likely to be appropriate where the volume of output is not stable and asset prices are changing. Appropriately defined economic asset lives should be defined. For other assets, other methods such as straight line depreciation may be reasonable for practical reasons.

Relevant profit

The ERT must ensure that the retail offers of the SMP operator recover downstream costs, including a return on capital employed, and the wholesale charge. The return on investment required is generally measured by the Weighted Average Cost of Capital (WACC). In keeping with its position on the adjusted EOO, Vodafone considers that there may be merit to adjust the WACC of the SMP operator to better reflect the WACC of a suitably defined hypothetical new entrant.

Downstream costs and usage profile

It goes without saying that **ALL** relevant downstream costs should be included (e.g. retail cost, own network costs, common costs, cancellation cost) in addition to applicable regulated wholesale input costs and appropriately discounted. Cost should be grouped in sufficiently granular cost categories (customer care, etc) having regard to the materiality of certain costs.

Costs should be allocated using appropriate bases using economic principles (e.g. cost causation). Not doing so can lead to significant distortions as exemplified in the UK where Ofcom has proposed to allocate BT Sport content cost across all broadband users and not against those who make use of the services. Regulators should also pay special attention to how common cost between services subject to the ERT and other services are allocated.

While the SMP operator's cost base can be taken as a starting point where the costs are appropriately audited, adjustments are likely to be required for the adjusted EEO test (see above). This may require the use of usage profiles different to those of the SMP operator.

To prevent gaming by the incumbent and offer access seekers the necessary level of assurance regarding the robustness and appropriateness of the information on costs and usage, NRAs should mandate a third party to audit the information.

Relevant wholesale inputs and costs

The Recommendation requires NRAs to identify the most relevant regulated wholesale input, which may be an active input, a passive input non-physical or virtual input offering equivalent functionalities to a passive input. The Recommendation also envisages the possibility to use a different input where this input is expected to become more prominent (e.g. fibre unbundling at the ODF).

The wording of Article 49 suggests that passive wholesale inputs will remain subject to cost base regulation. Vodafone therefore submits that the ERT should be based on the most appropriate active NGA wholesale input offered on an EOI basis used to replicate the downstream service.

Vodafone agrees that where a mix of relevant wholesale services is used, this should reflect the approach of an efficient operator and be consistent with the adjusted EOO approach.

Innovative pricing arrangements, such as long term access pricing agreements and two-part tariffs can be an important tool to foster NGA investment, especially to mitigate demand risk. Consistent with the EC recommendation Vodafone supports that "NRAs should give due weight to the presence of volume discounts and/or long-term access pricing agreements between the SMP operator and access seekers".[5]

Retail products, price and levels of aggregation

Vodafone believes BEREC's guidance document requires more detail and firmer guidance on the products and/or offers which will be subject to the ERT as well as their pricing and levels of aggregation.

Considering that NGA offers are still nascent and constantly evolving with new offers being launch regularly, it is important to understand the notion of "flagship products" in a wider sense. Clearly, a definition purely based on revenue and customer market share is not sufficient in the fast changing NGA environment.

Taking a principled-based approach consistent with the purpose of the ERT to safeguard competition by ensuring replicability of the SMP operator' offers, Vodafone considers that offers that present a material risk to competition should be subject to the ERT.

Operationally, Vodafone submits that a variety of indicators should be considered in order to define relevant flagship products. At the outset, Vodafone agrees that market and customer revenue shares are appropriate metrics for deciding on a first set of flagship products. The materiality threshold Vodafone suggests here is 10%.

In addition to that and taken account of the fact that not all products which pose a material risk to competition may pass this threshold, Vodafone believes that a set of additional factors need to be assessed. These are:

- Absolute customer growth in the product segment
- Gross net additions in comparison to other NGA products

[5] OJ L 251, 21.9.2013, p. 28.

- Marketing and advertisement spend as % of total spend in the segment, as this indicates the potential importance of the incumbent before product launch
- Offers targeted at customer upgrading from copper based to NGA based offers.

In a market where SMP operators continue to enjoy substantial market shares in copper based broadband and there are barriers to switching it is important that they are prevented from leveraging their existing customer base in copper based broadband to NGA. A properly designed ERT should screen offers from SMP operators that migrate customers from copper to NGA based retail offers.

The level of aggregation of the ERT is another critical choice as it may affect the outcome of the ERT. Vodafone submits that a portfolio approach (as implemented by Ofcom) falls short of meeting the purpose of the ERT. Under the portfolio approach, the SMP operator could make lower, none or negative margins on a proportion of services. Vodaonfe considers that this approach is flawed, subject to gaming and fails to achieve the objective of the margin squeeze test. It is also skewed to favour the SMP operator who is likely to have a wider service / portfolio range than its competitors. The SMP operator would be incentivised to abuse its dominant position in certain product lines while still satisfying the overall ERT.

Vodafone therefore rejects the portfolio approach. A flagship product by flagship product (e.g. Triple play offer) approach (which looks at whether the revenues are sufficient to recover the relevant downstream costs including a mark-up for common costs, wholesale input costs and other relevant costs) should be used. Vodafone thus requires BEREC to provide clear guidance on this to prevent anti-competitive behaviour.

Vodafone agrees with BEREC that the ERT should consider both bundle and stand-alone offers and that all downstream revenues need to be taken into account.

Further, Vodafone submits that where geographical segmentation may be required this needs to be assessed on a case-by-case basis.

Promotions and discounts

Vodafone supports BEREC's proposal to consider promotions along with temporary discounts. In order to ensure a competitive level playing all price discounts even if they are of temporary nature need to be reflected. Given the dynamic nature of the NGA market this is of particular importance.

Consideration of bundles

In line with its previous comments, Vodafone believes that all bundles which include at least one element based on the NGA wholesale input need to be considered when performing the ERT. In light of the evidence that quad play offers may be increasingly prevalent in the future, Vodafone submits that the test design must appropriately cater for important market trends.

Test for bundles should look at the total revenue from the bundle and all the underlying cost necessary for the production of the component of the bundle. NRAs should refrain from imputing the value of an element of the bundle from its standalone price as this is arbitrary and is unlikely to be a good proxy of the cost and the price of each individual bundle component.

Products for business customers should be included in the ERT

Business offers that rely on the regulated NGA wholesale input should be subject to the ERT in the same way consumer products are. Incumbent market power has remained strong for these offers which are typically targeted to SOHO customers. Their exclusion from the scope of the ERT would mean the SMP operators could set retail prices with no regulatory constraint, in contradiction with the Recommendation.

Vodafone therefore requests that BEREC makes it clear in the final Guidance that business offers should be subject to the ERT.

Profitability of products over time (static and dynamic approach)

Vodafone supports the EC recommendation requiring to 'evaluate the profitability (…) on the basis of a dynamic multi-period analysis'[6] utilising a discounted cash flow approach with customer lifetime set in accordance with the adjusted EEO standard. However, considering the drawbacks of the DCF method rightly pointed out by BEREC, Vodafone believes that in order for the ERT to be effective at safeguarding competition and to appropriately assess profitability of dynamic products over time, a period-by period analysis with certain cost categories appropriately spread over the customer life time (e.g.

[6] OJ L 251, 21.9.2013, p. 28.

customer acquisition costs) should also be included in the ERT. Considering that this is independent of national circumstances, Vodafone submits that this should apply across all Member States.

Procedural and transparency issues

Vodafone submits that a robust compliance and monitoring framework is an integral part of the ERT. Both the EC recommendation and the guidance document take a very generic position on this matter and lack clarity in terms of practical implementation.

As rightly pointed out in the EC's recommendation it is important that NRAs "set out and make public in advance [...] the procedure and parameters it will apply when running the ex-ante economic replicability test". In line with the recommendation Vodafone requires NRAs to consult upon and give guidance on both the structure and details of the test before implementation.

In addition to a comprehensive consultation on the adequate methodology of the ERT it is important that NRA's disclose input parameter at an aggregated level together with applicable calculations and ERT model workings to determine the margin squeeze at a practical level.

In order to reduce gaming opportunities and minimise the risk of margin squeeze prior to products launch on an ex ante basis, Vodafone considers that pre-notification is essential to effectively protect competition. The SMP operator must be required to supply pre-launch notification of major price changes and new offers showing compliance with the no margin squeeze obligation.

Further, a monitoring system must be in place to ensure compliance based on actual data on an ex post basis. To that end Vodafone proposes an obligation on the SMP operator to provide information that shows the compliance with the test on a quarterly basis.

In order to validate the submitted quarterly submissions, Vodafone also suggests that a third party should verify the information, including data on traffic) submitted as part of the ex-post reporting requirements placed on the SMP operator.

The NRA should carefully review the information and promptly notify access seekers in case of margin squeeze.

Competitors should be able to request the NRA to perform an ERT on a particular NGA product when they consider that there is a potential compliance breach by the SMP operator with the ERT.

Taking utmost account of transparency Vodafone believes that information about the conduct of the test and non-confidential data should be publicly available.

NRAs should promptly remove any squeeze identified.

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