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ANNEX 3

ANNEX

to the

Commission Recommendation

on the regulatory promotion of Gigabit connectivity

ANNEX III

Parameters of the *ex-ante* economic replicability test referred to in point 43 of the Recommendation.

When the national regulatory authority (NRA) decides not to impose or maintain regulated wholesale access prices on VHC wholesale inputs, pursuant to Article 74 of Directive (EU) 2018/1972, the *ex-ante* economic replicability test referred to in [point 43] of this Recommendation assesses whether the margin between the retail price of the relevant retail products and the price of the relevant VHCN-based regulated wholesale access inputs covers the incremental downstream costs and a reasonable percentage of common costs. When setting the parameters of the *ex-ante* economic replicability test, NRAs should ensure that the significant market power (SMP) operator is neither put at an advantage nor at a disadvantage as compared with access seekers regarding the sharing of the investment risk.

The parameters referred to in [point 43(a)] of this Recommendation are:

Relevant downstream costs

- (1) Downstream costs are estimated on the basis of the costs of the SMP operator's own downstream businesses (Equally efficient Operator test). NRAs should use the SMP operator's audited downstream costs, provided that they are sufficiently disaggregated.
- (2) Where market entry or expansion has been impeded in the past (as shown for example, by past behavioural findings) or where very low numbers of lines and a significantly limited geographic reach as compared to the SMP operator's VHCN indicate that objective economic conditions do not favour the acquisition of scale by alternative operators, NRAs may, taking into account the level of competition on the retail market and competitive dynamics as identified in the market analysis, make adjustments for scale to the SMP operator's downstream costs in order to ensure that economic replicability is a realistic prospect. In such cases, the reasonably efficient scale identified by the NRA should not go beyond that of a market structure with a sufficient number of qualifying operators to ensure effective competition, bearing in mind also competition from other platforms. In conducting that assessment, NRAs should, in particular, take into account the following elements, as appropriate:
 - (a) the size of the largest competitors relative to that of the SMP operator;
 - (b) the number of **competitors** that are likely to be sustainable at each level of the value chain;
 - (c) the current HHI¹ at each **level** of the value chain and its expected evolution over time;
 - (d) the size of the VHCN market in the Member State (which might influence the number of competitors that can be economically sustainable).

Relevant cost standard

- (3) The incremental cost of providing the relevant downstream service is the appropriate standard. A long run incremental cost plus (LRIC+) model should be used to calculate

¹ The Herfindahl-Hirschman Index (HHI) is a commonly accepted measure of market concentration. It is calculated by squaring the market share of each firm competing in a market and then summing the resulting numbers. It can range from close to zero to 10,000.

the incremental cost (including sunk costs) and to add a mark-up for common costs related to the downstream activities.

Relevant regulated wholesale inputs and the relevant reference prices

- (4) NRAs should identify the most relevant regulated inputs used, or expected to be used, by access seekers, at the VHCN-based wholesale layer that is likely to be prevalent within the current market review period. The prevalent VHCN layer will depend on the SMP operator's rollout plans and chosen network topologies, as well as the take-up of wholesale offers.
- (5) Such an input may be active or passive. It may also be non-physical or virtual input offering equivalent functionalities to a passive input.
- (6) NRAs should carry out the *ex-ante* economic replicability test in order to assess the margin earned between the retail product(s) referred to in point 4 and the most relevant regulated input identified at the chosen VHCN-based wholesale layer.
- (7) In addition, where justified, in particular when a retail product referred to in point (iv) is launched based on a different input than the one previously identified, or when there is a substantial demand for access at a new VHCN-based wholesale layer, NRAs should also assess the margin earned between the retail product and the new VHCN regulated wholesale input.
- (8) If the SMP operator's network characteristics and the demand for wholesale offers vary greatly throughout the territory of a Member State, the NRA should assess the feasibility of differentiating the most relevant VHCN-based regulated wholesale layer by geographic area and adapt the test accordingly.
- (9) When identifying the relevant reference wholesale price, NRAs should consider the access price that the SMP operator effectively charges third-party access seekers for the relevant regulated wholesale input. Those wholesale access prices should be equivalent to the prices that the SMP operator charges to its own retail arm. In particular, in order to ensure the right balance in national circumstances between incentivising efficient and flexible pricing strategies at the wholesale level and at the same time ensuring a sufficient margin for access seekers to maintain sustainable competition, where a significant part of access seekers are actually receiving wholesale services at discounted prices, 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, ~~in particular where a significant part of access seekers are actually receiving wholesale services at discounted prices.~~ In most cases, however, long term discounts and volume discounts to wholesale prices should be disregarded when conducting the ERT.

Relevant retail products

- (10) NRAs should assess the most relevant retail products that include broadband services ('flagship products') offered by the SMP operator on the basis of the identified VHCN-based wholesale access layer. NRAs should identify flagship products on the basis of their current and forward-looking market observations, in particular taking account of their relevance for current and future competition. That should include an assessment of retail market shares in terms of the volume and value of products based on VHC network regulated wholesale inputs and, where available, advertising expenditure.
- (11) Flagship products are likely to be offered as a bundle. In the context of identifying flagship products and in the assessment of whether a bundled offer (containing offers including non-regulated components such as access to premium audio-visual content) constitutes a flagship product, NRAs should take into account the national circumstances such as the prevalence and nature of bundled offers in the specific market. Furthermore,

NRAs should assess innovative variations of such bundles, if they are likely to replace the flagship product.

- (12) NRAs should determine the level of aggregation (product-by-product or portfolio of products or also a multi-level or combined test) that is appropriate for the economic replicability test, in the light of the assessment of competition problems identified in the market analysis. In contestable those markets where competition at retail level is more developed, leaving more flexibility to the SMP operator through a portfolio approach may be justified. However, in markets in which the SMP operator has a high degree of concentration or a very high degree of market power, or both, a product-by-product assessment may be necessary to avoid cross-subsidisation between products and to enable alternative operators to compete on the various segments of the market.
- (13) In addition, NRAs should consider whether a particular retail product, which may not be among the most relevant retail products of the SMP operator, is particularly attractive to alternative operators that may focus on a certain niche or lower quality retail products. NRAs may decide to include such a product among the flagship products.

Relevant time period

- (14) NRAs should evaluate the profitability of the flagship products on the basis of a dynamic multi-period analysis, such as the discounted cash flow (DCF) approach. NRAs should identify an adequate reference time period over which to assess whether the margin between the retail price of the flagship product and the price of the relevant wholesale VHC access input allows for the recovery of downstream costs (including a reasonable percentage of common costs) calculated on the basis of points (1) and (2).
- (15) The relevant period for this *ex-ante* economic replicability test should be set in accordance with the estimated average customer lifetime. Such average customer lifetime would be the period of time over which the customer contributes to the recovery of both of the following categories:
- (16) The downstream costs that are annualised according to a depreciation method that is appropriate to the asset in question and the economic lifetime of the corresponding assets required for the retail operations (including network costs that are not included in the wholesale VHC access service);
- (17) Other downstream costs that are normally not annualised (typically subscriber acquisition costs) and which the operator incurs in order to gain customers, which it seeks to recover over customers' average lifetime.
- (18) When estimating the average customer lifetime, NRAs should take due account of the different characteristics and competitive conditions of the provision of services over VHC network compared to the legacy copper network, where these are likely to result in users of VHC network having different average customer lifetimes compared to users of the copper network.
- (19) The guidance provided for the *ex-ante* economic replicability test referred to in point 43 of this Recommendation and in this Annex is limited to the scope of this Recommendation, and therefore applies in different circumstances than *ex-ante* margin squeeze tests applied on regulated wholesale access prices. It is without prejudice to the application of the competition rules by the Commission and/or national competent authorities, and to their interpretation by the General Court and the Court of Justice of the European Union. This guidance is also without prejudice to any action that the Commission may take or any guidelines that the Commission may issue in the future on the application of competition law in the Union.