

**BoR PC05 (14) 07 Annex****Contribution to the Public Consultation on the Draft BEREC Guidance on the regulatory accounting approach to the economic replicability test (i.e. ex-ante/sector specific margin squeeze tests)****[BoR (14) 123]****Extracts of the Oxera Study for publication**

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In January 2014 Fastweb commissioned Oxera an independent assessment on the existing Italian margin squeeze test as well as guidelines on how the test should be modified to ensure its consistency with the regulatory practice and the 2013 Recommendation.

The ex-ante margin squeeze test is aimed at verifying if the alternative operators are able to duplicate the retail offers launched by the SMP operator. In order to do so, the test assesses whether the retail revenues earned by the SMP operator on the relevant offer are above or equal to the costs of providing the associated services. To measure the costs, the test could be applied by the NRA on a period-period (PbP) or on a multi-period discounted cash-flow (DCF) basis. The PbP test assesses the revenues and the costs of every new offer over a one-year period; the DCF test assesses the revenues and the costs of a portfolio of offers that belong to the same product family over a two-year period for the copper-based products and three years for fiber-based products.

In its analysis, Oxera warns against certain methodological choices in the design and the implementation of the ex-ante margin squeeze test as well as problems on test transparency that could render it ineffective in detecting and preventing possible margin squeeze.

Concerning the methodological choices in the design of the test, Oxera cautions NRAs on the definition of the cost standard, when carrying on the PbP, and on the data provided to and the time window chosen for running the DCF test.

When applying the PbP test, Oxera recommends to NRAs not to consider only marginal/variable costs standard, as the exclusion of fixed costs from the test is not only inconsistent with the best regulatory practice but it may have important implications on the effectiveness of the test- as it will not take into consideration “*a key cost element faced by alternative operators*”<sup>1</sup>- and for the investment incentives of alternative operators. By choosing to exclude from the test the fixed costs, which are a substantial component of the entrant’s cost base, the alternative operators will not be motivated to expand their networks but, instead, be pushed to acquire more inputs from the SMP operator. Moreover, Oxera considers important not

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<sup>1</sup> Economic Assessment of AGCOM’s ex ante margin squeeze, January 2014, Oxera, page 11;



to exclude from the scope of the PbP test short-terms promotions and innovative services to reduce gaming opportunities of the SMP operator.

**Consequently, Oxera recommends to the NRAs in order to maintain an effective ex-ante margin squeeze test to “estimate the retail costs components using a robust methodology that is in line with best regulatory practice, as bottom-up/top-down cost models<sup>2</sup>” and stresses, furthermore, that also “the European Commission relies on the LRIC benchmark to measure the costs of the undertaking’s downstream activities”<sup>3</sup>.**

When applying the DCF test, Oxera considers it essential in order to minimise gaming opportunities of the SMP operator to ensure that the data on volume and take-up provided to the NRA for running the test are not forecast data but data that can be easily verified and audited by the NRA. Oxera underlines that the data provided “*should be consistent with the information contained in the regulatory and managed accounts of the SMP operator*”<sup>4</sup>.

Furthermore, the time window for running the test should not be fixed and too long, as it could create additional gaming possibilities for the SMP operator. In fact, if the time window is kept fixed over a certain period of time (i.e. one year) and restarted at the beginning of each time period, it could allow the SMP operator to “*increase its net present value of the estimated profit over the analysed period by launching its most aggressive offers at/towards the end of each year*”<sup>5</sup>. “*In doing so, the potentially smaller or even negative margins associated with the offer would be considered for a shorter period of time than those launched at the start of the year, thereby giving to the SMP operator the opportunity to artificially increase the net present value of the test*”<sup>6</sup>.

Moreover, Oxera considers essential - in order to avoid that potential anti-competitive pricing behavior could pass undetected –to include in the DCF test add-services which will be adopted by a large majority of new subscribers.

**In view of the above, Oxera recommends “applying a time window on a rolling basis to ensure that all offers are analysed for the full average customer lifetime”<sup>7</sup> and “introducing” - in order to strengthen the accuracy of the data provided to the NRA – “an additional test on top of the ex-ante DCF test that would analyse all new offers launched by the SMP operator (including short-term promotion and innovative offers that are currently exempted from the PbP test) on a stand-alone basis over a two year period (three year for the NGA services). This test is expected to improve the likelihood of detecting offers that have the potential to lead to margin squeeze in the market”<sup>8</sup>.**

<sup>2</sup> Economic Assessment of AGCOM’s ex ante margin squeeze, January 2014, Oxera, pages 3 and 17;

<sup>3</sup> Economic Assessment of AGCOM’s ex ante margin squeeze, January 2014, Oxera, page 11;

<sup>4</sup> Economic Assessment of AGCOM’s ex ante margin squeeze, January 2014, Oxera, page 4;

<sup>5</sup> Economic Assessment of AGCOM’s ex ante margin squeeze, January 2014, Oxera, page 15;

<sup>6</sup> Economic Assessment of AGCOM’s ex ante margin squeeze, January 2014, Oxera, page 2;

<sup>7</sup> Economic Assessment of AGCOM’s ex ante margin squeeze, January 2014, Oxera, pages 4 and 18;

<sup>8</sup> Economic Assessment of AGCOM’s ex ante margin squeeze, January 2014, Oxera, pages 5 and 18;



Finally, Oxera believes that a generic problem related to the ex-ante margin squeeze test is the lack of transparency of the methodology used by the NRAs in running it.

Oxera stresses the importance of increasing this transparency by providing more details on the methodology and on the parameters used as this would enable the stakeholders “to challenge the methodology and to help the NRA in monitoring its compliance”<sup>9</sup>. **In particular, Oxera deems it necessary to make transparent the following parameters:**

- *“how a reasonable return on capital is accounted for in estimating the downstream costs;*
- *how the regulatory accounts and the reference offer are used to measure the network costs related to the non-regulated component of the test;*
- *what the different levels of aggregation (or “families” in the DCF portfolio test) are;*
- *what revenues and costs are included in the wholesale, non-regulated and retail components in each test;*
- *how the NRA verifies the accuracy of the forecast data provided by the test;*
- *what action or regulatory remedies are envisaged in case of the SMP operator is failing one or more of the test”<sup>10</sup>.*

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<sup>9</sup> Economic Assessment of AGCOM’s ex ante margin squeeze, January 2014, Oxera, pages 4, 5 and 18;

<sup>10</sup> Economic Assessment of AGCOM’s ex ante margin squeeze, January 2014, Oxera, pages 4, 5 and 18.