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BEREC report on specific aspects of broadband commercialization

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1. Introduction

1. In the Working Programme for 2011, BEREC has acknowledged the importance of broadband in the future development of the economies in Europe. One of the key tools available for NRAs to promote broadband take up is enhancing competition as it affects directly on the value perceived by end users. Competition incentives innovation and efficiency, assuring the best deal to consumers and thus increasing their willingness to enter in the broadband market.
2. NRAs foster competition through the SMP regime imposing *ex ante* obligations, normally at wholesale level. BEREC has developed extensive work in the field of appropriate remedies in wholesale related markets (see common positions on WBA and WLA). However, to assure the effectiveness of wholesale remedies, in some cases, additional mechanisms have been put in place to avoid situations where the margins of alternative operators are squeezed by SMP operator's retail prices. BEREC has also given guidance to NRAs to effectively deal with these situations.
3. BEREC has noticed that commercial offers are becoming more complex as operators are adopting discounts and promotion schemes, mostly limited in time, which could reduce in a substantial manner the nominal prices of broadband services. It should be noted from the outset that, for as long as a number of conditions are met (in particular, transparency towards customers of the offers being made available) and competition in the broadband market is strong, such price reductions are positive and should be encouraged[1].
4. However, some alternative operators have raised this issue as it could hide price squeeze practices. This risk is higher if the NRA uses nominal prices to assess the consistency of retail offers given wholesale tariffs. This report shows that temporary discounts are available through all Member States and are used by all operators – and not just the SMP operator – as a powerful tool to compete in the broadband markets.
5. According to the benchmarking exercise carried out in this report, discounts differ broadly from one operator to another and from one Member State to another. In fact, reductions of nominal prices could affect the connection fee and equipments as well as the monthly fee, in general for a certain period of time. It is important to highlight that discounts could be very aggressive, either by their amount or the period of validity.
6. On the other hand, operators could impose loyalty clauses when consumers benefit from these price reductions. In these cases, the breach of loyalty clauses implies, in general, the payment of penalties by consumers. Again, the length of the period that consumers have to remain locked-in with the same operator and/or the penalties they have to incur in, such as termination penalties, vary from one European country to another.
7. This BEREC report focuses on the tools for analysis and potential means of wholesale intervention by NRAs regarding discount and promotional schemes (generally coupled with loyalty clauses) introduced by the WBA SMP operator during its economic relationship with the customer.

[1] Transparency issues are outside the specific scope of this report.

8. It underlines that there may be instances when aggressive long lasting discounts combined with loyalty clauses commercialised by the SMP operator could increase barriers to entry. This is more likely if wholesale conditions do not allow alternative operators to duplicate the effective prices observed by consumers. This report thus deals with this complex issue. The question of how to apply a price squeeze test in the context of retail discount schemes, through wholesale intervention (at the level of market 5 regulation) is also covered in detail.

9. It should be noted that specific issues pertaining to bundles have been covered by other BEREC documents, and are thus outside the scope of this report[2].

10. The document is structured according to the following sections:

    a. Brief background on the work already carried out by BEREC in the field of replicability of retail offers of the SMP operator, including actions to avoid price squeeze situations.

    b. Description of the most extended retail commercial practices of operators in broadband markets regarding discounts and loyalty clauses.

    c. Analysis of potential competition problems derived from temporary discounts associated with loyalty clauses.

    d. Description of possible approaches available for NRAs to tackle these competition problems.

2. Background

11. BEREC has already provided guidance to NRAs on the necessary consistency among wholesale and retail prices along the broadband services' chain. For example, the Report on ERG best practices on regulatory regimes in wholesale unbundled access and bitstream access[3] (rule 10) establishes that NRAs should assure the economic space between wholesale and retail prices to promote access of alternative operators in upstream rungs of the ladder of investment.

12. Moreover, BEREC has also referred to price squeeze situations, both in the context of standalone broadband services[4] or bundled offers[5]. In these documents the main problems related with price squeeze tests were analyzed, describing possible approaches to tackle them.

13. When defining a price squeeze BEREC documents take into account relevant competition law jurisprudence, which define price squeezes as those situations *"when an undertaking which is in a dominant position on the market for an unprocessed product and itself uses part of its production for the manufacture of a more processed product, while at the same time selling off surplus unprocessed product on the market, sets the price at which it sells the unprocessed product at such a level that those who purchase it do not have a*

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2 See in particular, http://erg.eu.int/doc/berec/bor_10_64.pdf

3 http://www.erg.eu.int/doc/publications/erg_07_53_wla_wba_bp_final_080604.pdf

4 http://www.erg.eu.int/doc/publications/erg_09_21_erg_report_on_price_consistency_in_upstream_bb_markets_090603.pdf

5 http://www.erg.eu.int/doc/publications/2009/erg_09_07_report_on_the_discussion_of_the_application_of_margin_squeeze_tests_to_bundles.pdf

sufficient profit margin on the processing to remain competitive on the market for the processed product"[6].

14. BEREC documents outline different methods of approaching price squeeze test including:
    a. Imputation test method
    b. Cost standard
    c. Relevant wholesale service
    d. Aggregation mechanism
15. Regarding loyalty clauses, BEREC has also discussed different manners to facilitate consumer switching from an end consumer perspective[7].
16. BEREC has already dealt with the possible manners of designing a price squeeze test in order to properly identify situations where SMP operator's retail prices do not allow to profitably compete given wholesale prices.
17. This report will now focus on how to apply a price squeeze in the context of discount schemes that affects effective prices moving them away from nominal prices, normally used by NRAs as the reference for the test.
18. It is very likely that the negative effects on competition resulting from a price squeeze get worse if switching costs are increased because the SMP operator can recoup initial costs during a longer period of time. For this reason, the report will also analyze the joint effects of price squeeze and loyalty clauses.

3. Description of discount schemes and other relevant retail practices

19. On February 2011, the Convergence and Economic Analysis Project Team circulated a questionnaire to NRAs to gather information about the existent discount schemes in each country. The answers to the questionnaire were received during the same month.
20. 26 NRAs replied to the questionnaire, including a relevant part of the larger European markets and countries where discounts in broadband offers are applied.
21. The evidence and conclusions presented in this section are based on the responses to this questionnaire.

3.1. Importance of promotions and temporary discounts in the retail strategy of operators

22. Generally speaking, offering temporary discounts or promotions to customers to facilitate their entry in the market is a common practice among the different European operators. This tendency is extended in most European countries. All the incumbent operators and the majority of alternative operators offer these discounts. The only exception is Switzerland, where none of the main operators

[6] Case T-5/97, judgment of the Court of First Instance of 30 November 2000. For a more recent manifestation of this principle, see Case C-280/08P, Deutsche Telekom, judgment of the Court of Justice of 14 October 2010.
[7] http://www.erg.eu.int/doc/berec/bor_10_34_rev1.pdf

offer temporal discounts. Moreover, the Danish authority points out that its national operators are reluctant to offer promotions, unless they are trying to boost new technologies (i.e. temporary discounts are currently offered following the recent VDSL-launch, but there are no discounts on ADSL).

23. On the other hand, it’s difficult to detect different strategies between the SMP and alternative operators in relation to the commercialization of broadband offers, when considering the specific characteristics of each individual country. In other words, temporary discounts are used by both incumbents and alternative operators (cable or ULL). Only in Slovenia, France and Czech Republic there are alternative operators that don’t apply any temporal discounts or promotions to new or current clients.

3.2. Forms of these promotions and temporary discounts

24. The content of promotional offers can be separated into two groups: (i) concepts that all customers have to pay when purchasing broadband products, such as equipment and the connection fee; and (ii) discounts on the monthly fee for a limited period, with the aim of promoting certain products over others (for instance, in the case of Italy, in general double play bundles receive this type of discount, but stand-alone broadband products do not).

25. Regarding the first group, most European operators give the equipment to their customers for free and also apply a 100% discount on the connection fee. On the other hand, currently none of the most prominent French telecommunication companies offers these two concepts with a discount. In other countries either the connection fee (Italy, Slovakia) or the equipment (FYROM) is discounted, but not both.

26. As stated above, the other promotional concept which is commonly granted to new customers is a discount on the monthly fees for a limited period of time. This practice is common among most operators even though national differences can be observed (this variability is however not as pronounced between the different operators in each country). The percentage of the discount offered is more variable between different national operators in countries such as Spain, Greece, Italy or Romania. It should be noted, though, that the discount measured in percentage terms must always be interpreted together with the difference between nominal prices.

27. As for the temporary extension of the discount, there are two main trends:

    a. Discounts are extended along the length of the entire fix-term contract, or, alternatively, distributed along the entire minimum contract period. This phenomenon is observed in 4 countries.

    b. Nevertheless, discounts on the monthly fee that are only applicable during the first months of the contract are more widespread, so that they are not connected to the minimum contract period. 13 of the surveyed countries present this trend.

28. Finally, NRAs were asked about the existence of periods during which the promotional intensity is higher, as it might be the case for Christmas. According to the responses received, the majority of the surveyed countries confirmed a higher intensity of discounted offers during promotional periods (15 countries).

3.3. Possibility of offering discounts to previous clients and loyalty clauses for existent customers

29. On the basis of national law or regulatory practice, is it possible to find, in most countries, operators –both incumbents and alternative operators- who offer to the same customer discounts or promotions on top of other discounts or promotions offered previously. Indeed, that is the case for all NRA who responded to this question (22 countries).

30. In 16 of the countries, operators include in their contracts loyalty clauses to the existent customers who have been granted additional promotions/discounts. On the other side, there are 5 countries where operators do not incorporate such clauses.

3.4. Minimum compromise period and penalties

31. Loyalty clauses are generally associated with a minimum contract period. The most common minimum contract period is 12 months (unique response in 10 countries), and it almost always ranges from 12 to 24 months (20 responses). The length of the minimum contract period does not generally depend on the operator (both the SMP operator and alternative operators use equal lengths).

32. In case the operator applies both a discount on the monthly fee and loyalty clauses, these clauses mainly enter into force from the moment the contract is signed (19 countries). The exception to this situation is only to be found in Germany (and solely by the main cable operator) and in Lithuania, where clauses come into effect when the discount is over. Besides, in the latter country the inclusion of these clauses depends on the conditions of certain promotions, and every operator might include it.

33. In the event of early termination of a broadband service contract which included a minimum contract period, the client might have to face a penalty. The most common penalty is to pay the remaining monthly fee until the end of the loyalty period (this happens in 9 countries out of 15 responses). Only in two countries there are operators which include clauses forcing the client to the payment of the remaining promotional costs, and in other two it is required to pay back the cost of the equipment (for instance, the router). Finally, there are several countries (9) where operators do include other defined penalties.

4. Potential competition problems derived from retail practices

34. As noted in the introduction, the focus of this report is to assess the competitive impact and means of intervention in the context of market 5 by NRAs when dealing with temporary discount schemes and loyalty clauses introduced by SMP operators in a market scenario where alternative xDSL offers coexist with the xDSL offers of the SMP operator or alternative fibre retail services are offered alongside the fibre offers of the SMP operator.

35. The existence of discounts and the other mentioned practices of the dominant operator may benefit the end user and promote the increase of broadband penetration. These practices might also be an indication of more competition in the retail broadband market or even in the wholesale related markets.

36. Notwithstanding, such practices, especially when applied by an SMP operator, may imply a risk for competition in the retail broadband market as discussed below.

37. It is important to clarify that BEREC does not have any concerns about the discounts and promotions that clearly benefit the consumers. The benefit of the consumers is precisely one of the goals of all NRAs actions. The concern is about commercial practices of the SMP operator that, even if it is at long or medium term, may harm competition in the market and, consequently, may also harm consumers.

4.1. Margin squeeze situations

38. As noted before, a margin squeeze (hereafter MS) is a situation where a vertically integrated firm with market power in a key upstream market, supplies rival firms in associated downstream markets and sets prices for the input and the downstream service in a way that renders unprofitable the activities of its competitors in the retail market. The practice of discounts and promotions in the retail market may cause a MS situation in three different manners:

<u>Leading to an effective reduction of the retail prices and, consequently, decreasing the margin between retail prices and wholesale costs.</u>

39. As mentioned above it is common that the SMP operator may offer temporary discounts in the monthly price paid by the consumer (usually in the first months of the contract) or else it may also offer, for free, the installation and the necessary equipments (e.g. modem) for the supply of a broadband service.

40. These offers imply sometimes a significant value at the beginning of the contract that must be recovered by the operator during the lifetime of that client with that operator. In this context, the operators usually condition the offer of discounts and promotions to a “loyalty” period of the client (see details in section 4.2).

41. These practices consist in an effective reduction of the relevant retail prices because they represent a reduction of the total revenue that the consumer generates for the operator during the average lifetime of the client with the operator.

<u>Increasing the wholesale costs needed to replicate the SMP operator’s promotional offers and, consequently, decreasing the margin between retail prices and wholesale costs.</u>

42. Other promotions of the SMP operator may include free unrestricted traffic, the increase of the bandwidth (or higher upload/download speeds) or even free service migrations for the end user.

43. If the alternative operators want to present the same kind of benefits to the end user this implies an increase of their relevant wholesale costs, since these are generally not offered for free at the wholesale level.

44. Even if there is a decision by the NRA stating that all these wholesale activities must be offered for free at the wholesale level, there might be a discrimination between the services in which the vertically integrated SMP operator is interested and other wholesale services that might be of more interest to the alternative operators (e.g. why should there be free unrestricted traffic for some offers and restricted traffic for others?).

<u>Increasing the retail specific costs needed to replicate the SMP operator's promotional offers.</u>

45. In this case the absolute margin between retail prices and wholesale costs is not affected directly by the practices. However, it must be considered that the bulk of retail specific costs supported by that margin increases and the margin between retail prices and wholesale costs may not be enough to support these retail costs.

46. The retail costs include all the relevant costs necessary to offer the broadband service in the retail market that are not covered by the wholesale services and activities. The retail costs depend on the specific characteristics of the retail offer provided (e.g. marketing costs, billing costs, offers and discounts offered to the client).

47. In fact, it is usual that the SMP operator offers to new clients other services or goods (even if not related with electronic communications).

48. Some of the practices of the SMP operator may also lead to an increase of the switching costs for the clients or even "lock" the clients for a limited period (especially if discounts are offered). In this case it becomes harder for the alternative operator to compete for those clients. This may also increase their retail specific cost because alternative operators must invest (marketing and advertisement costs) more to get an additional client.

49. To avoid MS situations and to increase the predictability of regulatory action some NRAs have developed and apply ex-ante MS tests to the SMP operator's retail offers. Generally in all of these ex-ante MS tests the discounts and promotions offered by the SMP operator are considered by the NRAs.

50. Another issue which is of relevance to NRAs is the value and frequency of promotions and discounts. The more frequent promotions and discounts become, the costlier it becomes to NRAs to regularly implement an ex ante MS control.

51. The MS test adopted by the NRAs should thus find the right balance between (i) the assurance of legal certainty and appropriate regulatory intervention, (ii) the predictability of this intervention, (iii) the minimization of regulatory and monitoring costs and (iv) the flexibility for the SMP operator to act in the retail market. Furthermore, the MS test should in principle be flexible enough to be applied to different structures of offers and discounts.

52. This issue will be discussed in more detail in section 5 of the document.

4.2. Increase in consumer's loyalty to SMP operator services

53. The setting of loyalty clauses in contracts signed between consumers and ISPs is a widespread practice in the EU. As it can be seen from the answers to the questionnaire, the vast majority of operators that engage in promotional activities (e.g. subsidization of equipment, or reductions in the monthly fee for a specified number of months) couple such efforts with the introduction of loyalty clauses (minimum contract periods). In most cases, the acceptance of the minimum contract period is a pre-requisite for granting these price reductions.

54. Loyalty clauses imply the development of an exclusive relationship between the customer and the operator for the services that are part of the contract, during a specified amount of time. Through the setting of loyalty clauses, the consumer's freedom to unilaterally cancel the contract before its expiration is restricted, as he will have to face the payment of the penalties specified for

such cancellation (be it an amount corresponding to the remaining months of the contract, a lump sum, or other). The customer is thus in principle locked-in with the operator of its choice for the time of the contract.

55. There appears to be no clear-cut position about the nature of loyalty clauses from a competition law or regulatory perspective, as both pro- and anti-competitive effects may be implied from the use of such instrument. It is however important to stress that loyalty clauses are in principle not abusive per se, and will require a careful analysis of the circumstances applicable to each case.

56. In particular, loyalty clauses can create the adequate incentives for operators to make a number of investments that they would otherwise not incur, by ensuring that the investment will be recouped during the lifetime of the contract period agreed upon with the consumer. This may be particularly true with regard to investments in new technology that need to be recovered over an extended period of time. From the perspective of the end user, the setting of loyalty clauses may enable a larger number of users to gain access to electronic communications services, thanks to the subsidization of equipment or other components (such as the connection price or the monthly fee) that are required to make use of the services. Loyalty clauses may also assist in solving "free-riding" problems, whereby consumers make use of the telecommunications services provided by an operator exclusively during the time the service is promoted, then switching to the promotions being made available by other operators.

57. On the other hand, loyalty clauses increase switching costs, making it more difficult for alternative operators to attract customers from the SMP operator, who are tied-in by a long-term exclusive relationship. If the costs of cancellation of the contract are higher than the benefits that the customer expects to reap from a change in provider (even in cases of customer dissatisfaction with its original service provider), the loyalty clauses can act as a clear disincentive for switching until the contract expires, thus leading to the creation of barriers to entry for alternative providers[8]. Switching costs can be particularly high when the services to be provided affect a bundle of services (e.g. double or triple play services), thus implying that most of the consumption of electronic communications services by the customer will be provided by one and the same operator.

58. Although increases in switching costs prevent customers from choosing alternative operators and, therefore, may delay potential benefits of effective competition, the effects of these increases are higher if they are combined with a MS conduct as it has been explained above.

59. In the context of the contracts signed by the SMP operator, the difficult issue is thus determining the minimum contract period that will allow both consumers and the ISP to maximize their incentives without affecting the development of competition. In general, it can be assumed that the longer the duration of the minimum contract period, the greater the risk of foreclosure and thus of competitive harm. Equivalent effects to those produced via the signing of extended minimum contract periods can be achieved through the setting of rollover contracts, which imply the automatic renewal of the minimum contract

[8] Likewise, a financial barrier may be created if the alternative operator has to bear the costs of cancellation of the contract in order to attract the customers of the SMP operator.

period initially set, thus implicitly also tying the customer with the SMP operator for prolonged periods of time[9].

60. It is also important to note that the issues pertaining to loyalty clauses are closely related to the specific penalties that will be borne by a consumer in the event of early termination of a contract. Indeed, the minimum contract period set by an operator will likely be less problematic, if the consumers have the chance of switching to other suppliers in exchange for a "reasonable" (e.g. cost-oriented and proportionate to the time already connected with the operator) cancellation fee. As it is the case with duration of the loyalty clauses, the higher the cancellation fee that is associated to a loyalty clause, the higher the risk of negative effects being derived from such clauses.

61. Another factor that may be worth considering is the point in time when loyalty clauses enter into force. As indicated by NRAs in their replies to the questionnaire, loyalty clauses generally enter into effect from the moment the contract is signed, i.e. at the same point in time when the discounts on which the loyalty clause is conditional start to apply. Alignment of the discount policy and the minimum contract period to the point in time when the contract is signed appears to be preferable to the enforcement of the minimum contract period only once the discount is over, in which case the non-overlapping of both commercial instruments would lead to an extension of the period of time during which the customer remains locked in with the SMP operator.

62. During the promotional period, discounted prices could be below market prices as these losses are recouped during the customers' lifetime. But precisely for this fact, the incentives to switch in this period are very low. If loyalty clauses are triggered only once the promotion is over, the total period when the customer is in one way or another locked-in with the SMP operator could be very high. According to the answers to the questionnaire, reduced prices could last up to 12 months or even more, whereas loyalty clauses can add up to 12 additional months. In total, if both periods are sequential, the consumer could therefore be locked-in for a period of up to 24 months.

5. Possible approaches to tackle potential competition problems

63. When NRAs are allowed to supervise retail offers or can identify market leverage instances by the SMP operator, these specific attributions have to be used in coherence with national consumers' protection law. If promotions and discounts are common on the broadband retail market, some consumer law provisions could be in place to improve ISP's commercial offers and broadband market fluidity.

64. These measures could be mainly related to transparency and information about the quality of service provided to end users when they subscribe to a broadband offer. Before subscription, end users need precise information about their eligibility and access to different services (internet, VoIP, IPTV and other TV services like VoD or HDTV). Therefore it is necessary to define precisely the services available as well as the discounts or promotions applicable, and make sure such information is understandable for end users.

9 In fact, the issue of rollover contracts was highlighted by NRAs as one topic of concern in BEREC's report on best practices to facilitate consumer switching, BoR (10) 34 Rev1.

65. In addition to general consumer law enforcement, a number of approaches are available to NRAs to tackle the issues related to temporary discounts and loyalty clauses. The following sections deal with the (i) ex ante communication of retail offers; (ii) the application of ex ante price squeeze tests; (iii) limitation of loyalty clauses.

5.1. Ex ante communication of retail offers

66. A particular mechanism that may contribute to prevent anticompetitive practices by WBA SMP operators when they offer discounts in the commercialization of broadband services at retail level consists in setting ex ante obligations on the SMP operator. The latter could be obliged to update its wholesale offers before it launches new retail services to allow competing operators enjoying access a reasonable period to react to the launch of such products, to ensure that they can be replicated by alternative operators.

67. NRAs can monitor retail offers through ex ante obligations despite the fact that regulation is mainly imposed at the wholesale level. Ex ante communication cannot generally be seen as a retail level intervention, as NRAs will impose such obligation to check that the conditions that the SMP operator offers at wholesale level to its own retail arm are the same than those offered to third parties and if these conditions do not threat competition in the retail market.

68. NRAs are empowered to request the information that they consider is necessary to ensure the fulfillment of the wholesale obligation, as it has been pointed out by the EC in its Explanatory Note[10] to the 2007 Recommendation on Relevant Markets regarding MS cases: *"[W]hen there is regulation at wholesale and/or retail level, the possibility of price or margin squeezes can result from regulatory intervention and it should be assessed in that context. That often involves checking the structure of regulated prices or the aggregate of services over which possible margin squeezes might arise. Article 5 of the Framework Directive provides NRAs with the legal basis to obtain any and all pertinent information, regardless of whether the market is identified in the annex to the Recommendation. This applies not only to costs but also to retail pricing in order to allow the NRA to establish and monitor justified and appropriate remedies with respect to wholesale access."*

69. Thus, provided appropriate price controls have been set in place, NRAs may wish to set an ex ante communication obligation which entails that operators have to communicate in advance to the NRA the commercial tariffs and discounts that they are about to launch to consumers, in order to ensure the sufficiency, including economic conditions, of wholesale obligations.

70. In fact, and according to the responses of the questionnaire, 6 NRAs have set an ex ante communication obligation of commercial offers, out of which 4 also analyze in advance these tariffs. On the other hand, some NRAs do analyze the commercial tariffs of the SMP operator without setting an ex ante communication obligation. The implementation of an ex-ante methodology to analyze the retail offers of the dominant operator (especially when the market

[10] EXPLANATORY NOTE Accompanying document to the Commission Recommendation on Relevant Product and Service Markets within the electronic communications sector susceptible to ex ante regulation in accordance with Directive 2002/21/EC of the European Parliament and of the Council on a common regulatory framework for electronic communications networks and services (C(2007) 5406).

knows the details of this methodology) may increase predictability and security of the regulatory intervention by the NRA.

71. This practice has been recommended by the EC[11] as a measure to avoid possible anticompetitive practices: *"the current wording of this prohibition [of any tariff differentiation which would allow the SMP to charge a wholesale tariff to its downstream arm] will not completely address the competition problem concerned. Firstly, because the prohibition is not complemented with requirements to provide specific costing data allowing for own initiative 'ex ante' monitoring by [the NRA]. Such monitoring also implies defining the parameters to assess the costs of an efficient competitor. Other NRAs have also obliged the incumbent operator to inform the regulator ex ante of in particular the prices of new retail products of the SMP operator on the basis of WBA"*[12].

72. In this regard, it has to be stressed that in many cases an ex ante obligation of advance communication may not be sufficient to tackle these possible problems. For this reason, some NRAs apply also systematically an ex ante MS procedure for the assessment of the SMP's retail offers[13] in order to avoid as much as possible any competition harm.

73. In this sense, even when the application of an ex ante MS test is an essential tool to detect and avoid harmful practices, the timing when these practices are detected is also of the utmost importance so, the sooner these practices are detected, the lesser the damage to the market. The best scenario is preventing the effective commercialization of anticompetitive retail offers by the SMP operator, which would lead to the imposition of an ex ante control measure whenever possible.

74. In brief, taking into account the special structure of the markets which, according to the EC 2007 Recommendation on Relevant Markets, are susceptible to be regulated ex ante (high and non-transitory barriers to entry, structure that does not tend towards effective competition within the relevant time horizon, insufficiency of the sole application of competition law alone to address the market failure(s) concerned), setting an ex ante communication obligation on the SMP operator's tariffs that are about to be launched, may allow regulators to avoid in advance possible market harm which could otherwise be irreversible.

5.2. Ex ante price squeeze test

75. NRAs are aware of the risks of margin squeezes in broadband markets as vertically integrated firms can increase wholesale prices, reduce retail prices or both to prevent alternative operators from reaching acceptable levels of profitability. Indeed, as noted there are some NRAs that have introduced, through the SMP regime, an ex ante obligation on the SMP operator to communicate retail offers in advance in order to analyze them.

76. In addition, while recognizing that differences in national circumstances[14] may warrant different approaches to MS tests, BEREC has already touched some technical aspects of price squeeze tests, including the general recommendation to assure enough economic space between wholesale and

[11] In this regard, see comments of the European Commission of 8 December 2008 in cases *NL/2008/0826 and NL/2008/0827*.
[12] However, it should be noted, that this recommendation pertains to a specific case and cannot be taken as a general rule.
[13] *Report on price consistency in upstream broadband markets ERG (09) 21.*
[14] And even different weighting of the different objectives of NRAs.

retail prices. However, the generalization among Member States of aggressive discounts, that could reduce nominal prices up to 40%, deserves an individual treatment in this paper as some additional considerations have to be taken into account.

77. Therefore, this section does not pretend to analyze the technical elements of an ex ante test but, where such a test is necessary, how to implement it in a flexible enough manner to detect the squeeze in alternative operators' margins, also assuring on the other hand the sufficient commercial freedom to the SMP operator so that non distorted competition brings benefits to consumers through better prices.

78. Price squeeze tests measure the downstream profitability of an efficient operator which is providing broadband services. In doing so, NRAs usually have to take into account the retail conditions of the SMP operator in order to compare them with the costs of an efficient operator, assuming that it is using the wholesale services provided by the SMP operator.

79. Downstream profitability is affected by discounts, especially if such discounts are substantial. However, while their treatment in an ex post test is relatively straightforward, it may involve some modifications in the ex ante MS test that could make it more complicated. As it has been described above, discounts could have several forms such as subsidization of one-off costs or a temporary reduction in the monthly fees or even for the customers' lifetime (the contracting window on the other hand being limited to specific periods of time). On the other hand, discounts can be offered at the moment when the contract is signed or during the whole economic life of the customer.

80. Given this situation, NRAs have to decide when these price reductions should lead to a reduction in wholesale prices to ensure an appropriate level of profitability that assures non distorted competition. For this reason, NRAs have to determine the scale of the said discounts and the time window when such discounts are applicable.

81. These elements are analyzed in the following paragraphs.

5.2.1. Nominal price vs. Temporary discount

82. Operators set the price of their services in nominal terms. These nominal prices could be adjusted through temporary discounts that could be linked either to a specific period of the year (i.e. Christmas) or to a certain type of customer (such as new customers). Once the promotional period has elapsed, nominal prices return back to those applied before the adjustments were undertaken.

83. There is a risk of consumers getting misled on the actual nominal price of the broadband product/service, especially if they assume that the discounted price is the actual price. In fact, discounts to existing customers are also granted by some SMP operators that link together a sequence of different discounts.

84. At the end of the day, if the commercial policy implemented by the operators is the one described immediately above, consumers will choose the operator because of the promotion observed, rather than by the nominal prices fixed by the operator. They will assume that once the current promotion is finished, the operator will offer a new discount.

85. NRAs have to evaluate in this situation if the treatment within the price squeeze test should be different. Wholesale prices should allow alternative operators to replicate profitably the dominant operator's retail offers. The discounts and

promotions offered by the dominant operator should be considered by the NRAs when assessing the existence of a price squeeze situation because they represent an effective reduction of the nominal prices.

86. NRAs may possibly ponder the existence of a base of clients that might have not benefited from any discounts. Nevertheless, when the discount practices become more common and universal it might be appropriate to consider that all consumers are benefiting from the discounts.

87. The consideration of discounts and promotions is even more necessary when the dominant operator “links” various promotions and, consequently, the end user never pays the nominal price.

88. In these cases, however, NRAs will face an additional burden of proof because it is not straightforward identifying and proving that the SMP operator is linking promotions to reduce the nominal prices. This operator could offer through its sale chain discounts designed for new customers (and as such communicated to the NRA) also to existing customers. Another form of avoiding that the customer pays nominal prices is offering discounts to existing customers different from those offered to new ones.

89. In conclusion, discounts and promotions affect the revenue customers generate to the operators and should be considered in the margin squeeze analysis. This is more obvious when sequential temporary discounts are applied and the nominal price is never paid by the customers. At the same time the consideration of discounts and promotions should ensure enough commercial freedom to the SMP operator to adapt to market conditions.

90. In the following section temporary discounts are tackled.

5.2.2. Treatment of temporary discounts

91. As mentioned, BEREC considers that temporary discounts, offered either at the moment of connection or during the consumer’s lifetime, should be considered in the price squeeze test applied, because they affect the turnover received by the SMP operator. As it has been said, discounts could reduce the price of one-off concepts (i.e. equipment or connection fee) or the monthly fee. To consider the first ones in an appropriate way, NRAs should consider the whole consumer’s lifetime, because acquisition costs are recouped during this period.

92. From the operators’ perspective, it may be considered reasonable to set an initial price for a product that does not cover the costs of serving the customer in the first months, but which is sustainable once the customer pays the whole monthly fee. The price squeeze test adopted by NRAs should not prevent the SMP operator from pursing legitimate competitive strategies such as subsidization of one-off costs. However, this operator should also be able to recoup these costs in a reasonable period of time and, in any case, during the lifetime of the customer.

93. Therefore, the price squeeze test, to deal properly with discounts, should analyze the following parameters:

   a. Appropriate framework for the analysis of profitability.

   b. Economic life of the customer.

   c. Suitable unit of analysis.

Framework for the analysis of profitability

94. As it has been said above, a price squeeze test has to evaluate downstream profitability, which can be calculated with different approaches. On the one hand, NRAs could opt for the approach used by competition authorities, which is based on the historical costs of the operator. This approach spreads some cash-flows forward and backwards over the periods to which they relate, so that income is matched with applicable costs in any given period.

95. However, from an ex ante perspective (where the forward looking analysis is a key element that should be taken on board), historical costs might not be suitable. Another approach to evaluate price squeeze is thus calculating the net present value (NPV) of the customer that is purchasing a service. This approach assesses the overall profitability of a business or investment project over the lifetime of the business or project. If forward looking, business plan forecasts are used. NPV compares cash receipts with payments over time, discounted to reflect the time value of money.

96. In this last case, connecting a customer can be seen as an investment project, and if the NPV is positive for an efficient operator that uses regulated wholesale services, then its margins are not squeezed by the SMP operator. In this scenario, communicated retail conditions, and thus, nominal prices together with discount schemes, have to be considered as the future cash flows to evaluate the NPV. On the other hand, NRAs will have to do their best estimation on future costs.

Economic life of the customer

97. In a competitive market, operators will have to fiercely compete to gain additional customers for their platforms. To do so, operators have to reduce (or even fully subsidize) the switching costs that consumers could face. Moreover, if prices are already at their competitive level, operators could be forced to reduce them below this level to attract new customers through promotional periods. This could imply selling below cost at least during the promotional period. However, once this period is over, consumers will have to pay the full monthly fee, allowing operators to recoup these costs.

98. NRAs should bear this in mind when defining the price squeeze test. The behavior described above is rational in a competitive environment, both for the SMP operator and the alternative operators, and therefore should in principle not be prevented. For this reason, calculation of the economic life of the customers seems a key element of the test, as acquisition costs should be distributed during this period.

99. Consumers could behave in very different manners when making switching decisions, as several factors could be affecting them. Factors such as the competitive conditions observed by consumers could increase their willingness to change their operator as competition increases their awareness of retail conditions. On the other hand, contract clauses, such as minimum contract periods and penalties could refrain end users from switching.

100. For the reasons above it might be difficult to calculate the average period during which consumers are connected to the same operator, that is, the economic life of the customer. In any case, NRAs, taking into account data available in the market provided by the operators (e.g. churn rate) may estimate the average economic life of customers. In this estimation, NRAs should weigh efficiency standards as the average economic life of the SMP operator customers could be higher than the ones faced by alternative operators (as the SMP operator has the advantage of incumbency and

therefore a large installed base that may not churn, whereas alternative operators' customer bases tend to be customers that have churned from the SMP operator and are more likely to churn again).

Unit of analysis

101. In general operators incentivize the consumption of certain products by promoting them through aggressive discounts, whereas other products of their portfolio are only sold at the consumer's request. The ex ante analysis could be performed by taking into account all products or individual offers. NRAs have to decide which shall be their unit of analysis taking into account the specific characteristics of their national markets.

102. Considering all products allows the most straightforward comparison of revenues and costs. If individual offers were to be considered, then applying any cost standard may require the exclusion of costs that are common to more than one product (such as management, some marketing and certain network costs) on the basis that those costs are not relevant to incremental decisions regarding the individual product (which should be assessed in terms of their contribution to recovery of common costs).

103. However, in some circumstances, it may be appropriate to conduct the test at the level of each individual offer. This could for instance be the case for a new offer giving rise to a MS, which is currently subsidized by other profitable offers but whose volumes could increase substantially in the future, subsequently leading to an overall negative margin in the future. When the test is performed at each individual offer the alternative operators also have the security that they have an appropriate margin in all segments of the retail markets and can enter in niche markets.

104. The more aggregated the approach, the more favorable this approach is to the SMP operator, as it gives maximal flexibility to spread the costs which are common to its retail products (provided that the MS test yields a positive result with the aggregated approach). However, this flexibility could increase barriers to entry if the SMP operator subsidizes customers who are more price sensitive, therefore lowering their willingness to switch to an alternative operator.

105. It is important to consider that SMP operators offer a wide range of retail broadband products with a correspondingly wide range of prices, which leads to the issue of implementation problems. Taking the individual offer approach could lead to the analysis of an important amount of offers as well as to the difficulties associated with the ex ante assessment of the impact of particular offers on demand, increasing the burden of regulation both for SMP operators and NRAs.

5.3. Limitation of loyalty clauses

106. As indicated earlier, loyalty clauses entered into by an SMP operator cannot be deemed to be per se abusive, and will require a case-by-case analysis.

107. From the point of view of NRA intervention, ex ante regulation may have a limited impact, as loyalty clauses constitute a retail practice, and the EU framework sets a clear preference for wholesale intervention. In fact, NRAs mainly regulate wholesale markets in accordance to the Recommendation.

108. In this regard, the consideration of competition law principles (as applied to the SMP operator) and general consumer law principles (as applied generally to all operators) may be helpful in deciding on the correct approach to loyalty clauses.

Competition law principles

109. As noted in the European Commission's Guidance on the enforcement priorities in applying Article [102 TFEU] to abusive exclusionary conduct by dominant undertakings[15], *"if competitors can compete on equal terms for each individual customer's entire demand, exclusive purchasing obligations are generally unlikely to hamper effective competition unless the switching of supplier by customers is rendered difficult due to the duration of the exclusive purchasing obligation. In general, the longer the duration of the obligation, the greater the likely foreclosure effect. However, if the dominant undertaking is an unavoidable trading partner for all or most customers, even an exclusive purchasing obligation of short duration can lead to anti-competitive foreclosure"*.

110. From a competition law perspective, two issues will therefore be critical to address the potential anticompetitive foreclosure effects derived from loyalty clauses: (i) the length of the minimum contract period (duration), and (ii) the penalties derived from non-compliance with the minimum contract period.

111. As noted by the EC, the longer the duration of the minimum contract period (or correspondingly, the higher the amount of the penalty that must be borne by the consumer to terminate the contract) the greater the risk of foreclosure and thus of competitive harm.

112. While under competition law it would be very difficult to establish a pre-determined time period beyond which loyalty clauses would be deemed anticompetitive, a number of elements may assist NRAs in ascertaining the pro- and anticompetitive effects of a loyalty clause introduced by the SMP operator as part of its pricing scheme. These include:

- An assessment of whether the loyalty clause is linked to a real investment effort undertaken by the SMP operator. This might for instance not be the case if the retail offers that are subject to a minimum contract period are essentially the same than earlier or contemporaneous retail offers of the SMP operator that did not contemplate a minimum contract period as part of the conditions.
- An assessment of whether the introduction of loyalty clauses is a general trend in the market (and is thus implemented also by alternative operators) or is a practice that is being unilaterally undertaken by the SMP operator.
- An analysis of whether the minimum contract period and the compensation that will have to be paid to the SMP operator in case of early termination of the contract are aligned to what constitutes normal market practice, and can be said to be "reasonable" taking into account the investment efforts undertaken by the SMP operator and the time elapsed since the signing of the initial contract.
- Consideration of whether the minimum contract period can in practice be longer than what is initially contemplated, e.g. due to the existence of automatic renewal provisions, or due to the delayed entry into effect of the minimum contract period (for instance, only once the discounts have been effectively granted to the customer).

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[15] OJEU C45/7 of 24 February 2009, § 36.

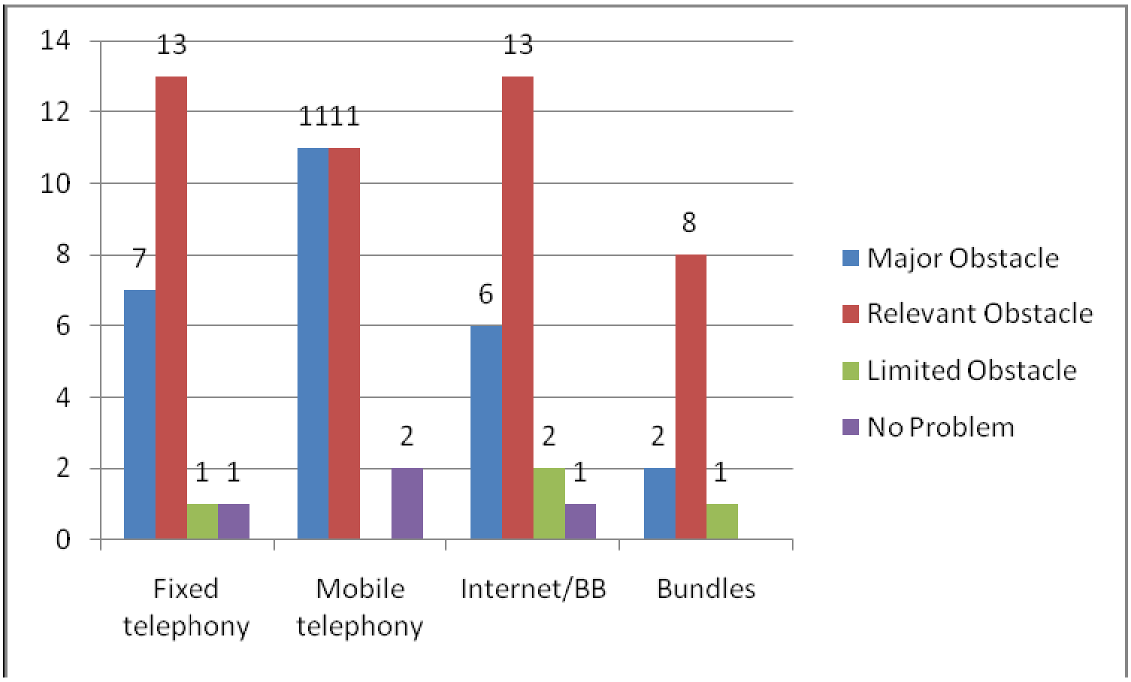
- An evaluation of whether the subsidized concepts that lead to the introduction of the loyalty clause (and the penalties associated in case of early termination) are perceived by the customers as providing real added-value. For instance, in some jurisdictions, customers may assume that the modem-router or the connection fee will in any event be subsidized as this has become a standard market practice, thus making it unreasonable to make such commercial activities subject to a loyalty clause.

Consumer law

113. The lock-in effects derived from loyalty clauses can also be addressed from the perspective of general consumer law. As it has been noted by some NRAs, consumer protection law constitutes an extensive body of mandatory regulation, the aim of which is to counterbalance the weaker position that consumers are presumed to have in relation to their counterparties (electronic communications operators) in the market. The primary aim of consumer law regulation is to ensure that consumers have access to the information they need to make well-informed decisions, and to ensure that businesses do not exploit their stronger position to negotiate imbalanced and unreasonable contracts[16].

114. As indicated in BEREC's report on best practices to facilitate consumer switching[17], NRAs have identified contractual provisions as the biggest obstacle to switching, this being the main concern for all telecommunications sectors (fixed telephony, mobile telephony, internet/broadband and bundles). This conclusion is highlighted by the following table, which summarizes the answers provided by NRAs to the questionnaire that was submitted in that regard.

Obstacles to switching: contractual obstacles



Source: BEREC's report on best practices to facilitate consumer switching, Table 19.

16 PTS, *"The possibility to switch – A survey and analysis of conditions in consumer contracts that affect customer mobility in the electronic communications market"*, October 2010.
17 BoR (10) 34 Rev1.

115. BEREC's report on best practices to facilitate consumer switching thus identify as an area for future work the transparency of customer information, including the transparency and fairness of additional charges, e.g. early termination charges and minimum contract periods, in light of contractual obstacles having been identified as the main obstacle to switching.

116. In this context, it is worth noting that Directive 2009/136/EC of 25 November 2009 amends Article 30§5 of the Universal Service Directive, which now reads that "Member States shall ensure that contracts concluded between consumers and undertakings providing electronic communications services do not mandate an initial commitment period that exceeds 24 months. Member States shall also ensure that undertakings offer users the possibility to subscribe to a contract with a maximum duration of 12 months"18.

117. A number of jurisdictions, including Croatia, Finland, France, Germany, Netherlands or Portugal, have already enacted legislation that limit the maximum contract period to 24 months, service providers also being required in Finland to make available an offer with a contract period of less than 12 months in the event that offers of more than 12 months are also commercialized.

118. As a related factor, the specific amount of the penalties that will have to be borne by a consumer in the event of early termination of a contract are also an issue that may be covered by consumer law provisions. As indicated in Article 30§6 of Directive 2009/136/EC, "without prejudice to any minimum contractual period, Member States shall ensure that conditions and procedures for contract termination do not act as a disincentive against changing service provider".

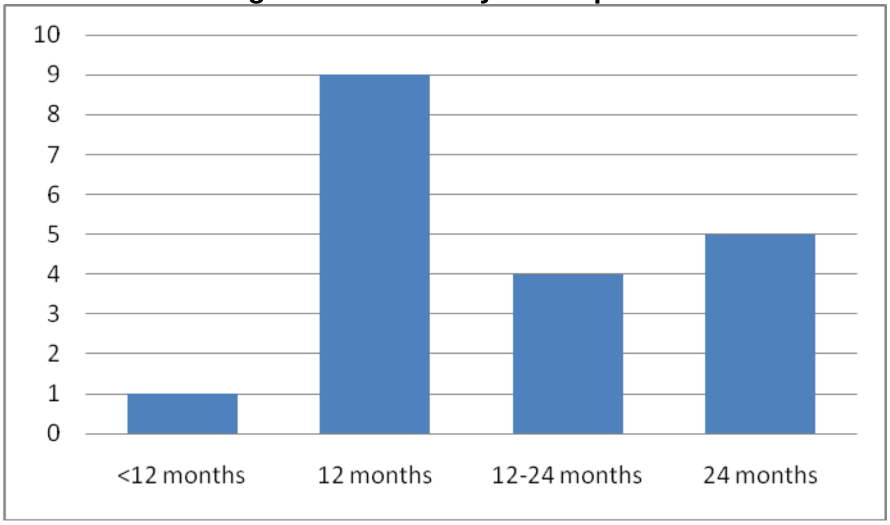
119. In this regard, consumer law provisions that ensure that, in the event of early termination, only the proportion of the cost of the equipment or promotional effort that is still outstanding will have to be paid (instead e.g. of a lump sum that is not necessarily related to the expenses actually incurred by the operator, or of payment of the outstanding monthly fees) could be important tools to facilitate switching between electronic communications operators.

120. While the transposition of Directive 2009/136/EC into national laws will undoubtedly mark a significant first step in many jurisdictions in order to limit the potential abusive use of loyalty clauses in contractual relationships, it will need to be seen – on the basis of national circumstances – whether a minimum period of 24 months might still be excessive from the point of view of sector-specific regulation and competition law, due to the risks of anticompetitive foreclosure that the introduction of such clauses by SMP operators might entail19. As a matter of fact, as it can be seen from the answers to the questionnaire, in those jurisdictions where the SMP operator has set for some of its products or services a minimum contract period, such compromise period is generally lower than 24 months.

[18] This amendment is related to Recital 47 of Directive 2009/136/EC, which states that *"it is essential to ensure that* [consumers can change providers] *without being hindered by legal, technical or practical obstacles, including contractual conditions, procedures, charges and so on. This does not preclude the imposition of reasonable minimum contract periods in consumer contracts […]"*.

19 As noted before, the 24-month maximum initial commitment period is without prejudice to the right of consumers to conclude a contract – probably, subject to a different pricing policy - with a lock-in period of no more than 12 months.

Length of MCP set by SMP operator



Source: NRA answers to Questionnaire (19 answers).

Conclusion

121. The previous paragraphs have dealt with the issue of loyalty clauses (minimum contract periods). Loyalty clauses are one of the key facets of the broadband commercialization strategies of SMP – and other – operators, as generally the grant of promotions or the application of a discounting policy is associated to the introduction of minimum contract periods that ensure the relationship of the customer with the operator for a given period of time.

122. From an ex ante regulation point of view, the perspectives for NRA intervention are likely to be limited as the setting of loyalty clauses is a retail practice, and retail markets are being progressively deregulated at EU level[20]. This perception is reaffirmed by the reduced degree of involvement by NRAs up to date on the issue of minimum contract periods through the pure application of ex ante principles. This is obviously without prejudice to the specific possibilities for intervention that NRAs may have been attributed, according to their own national laws.

123. On the other hand, competition law and general consumer law principles may have a role to play regarding the setting of loyalty clauses. However, with regard to competition law, it must be recognized that it will be difficult to define precisely what should be the appropriate period of time that will ensure that the (legitimate) aspirations of the SMP operator to recoup its investment in the customer are respected, while at the same time preventing the openness of the market, this leading to the necessity to undertake a case-by-case assessment. Likewise, consumer law principles may be of assistance in dealing with the issue of minimum compromise periods, but the application of such rules will generally respond to objectives that may be different from the pure promotion of competition (and e.g. extend to all operators, regardless of SMP status).

[20] However, market 1 (access to the public telephone network at a fixed location for residential and non-residential customers) is a market listed in the EC Recommendation and that may be susceptible to ex-ante regulation. In some cases, NRAs have established margin/price squeeze tests in that market. For example, Ireland's margin/price squeeze test, called a Net Revenue Test, which assesses the SMP operator's bundles that include retail fixed narrowband access.

6. Conclusion

124. Temporary discounts as well as subsidization of certain concepts on consumers' invoices are a general practice across all Member States according to the answers provided by NRAs. These commercial practices could reduce in a substantial manner nominal prices, becoming the essential tool for the development of competition in certain markets (where consumers are more aware of promotions than of the nominal prices that apply after the promotional period). It is also common that these discounts are granted only if the customer concludes a minimum contract period, which links the consumer and operator, during a minimum period of time.

125. Discounts (like other forms of price discrimination) and promotions have benefits on consumers as they imply a price reduction (in the monthly fees or in the one-off costs) or an improvement of the services provided. However, given their effects on retail prices or in the costs of operators, the downstream profitability of operators accessing the market thanks to existing wholesale services can be also reduced to a point that alternative competition is not sustainable. If loyalty clauses are added, switching costs can be increased, reducing potential demand of alternative operators by capturing the most price sensitive consumers.

126. This report has highlighted that all forms of discounts and promotions should be taken into account by NRAs as they have an impact on the margin of alternative operators. In addition, given their combined effects with loyalty clauses, these may be also considered in the analysis. However, regulatory costs can also be increased to an important extent if all individual offers are assessed so NRAs, depending on their resources, may have to reach an equilibrium on the granularity of the offers analyzed.

127. The report has also dealt with the several forms for tackling these problems, including general consumer empowerment or ex ante regulation within the SMP regime. It has been noted that NRAs, from a pure ex ante market analysis perspective, could find it difficult to intervene on the issue of setting of loyalty clauses by the SMP operator, because ex ante obligations are, in general, imposed at wholesale level.

128. On the other hand, NRAs are clearly empowered to deal with MS once wholesale markets are regulated, in order to ensure the effectiveness of the remedies set at such level. For this reason, BEREC estimates that monitoring MS cases is of the most importance, as avoiding these situations could solve to an important degree the problems derived from the grant of temporary discounts.

129. For this aim, NRAs should consider the imposition of an ex ante MS test which considers the effect of all discounts and promotions on nominal prices and costs. This may be combined with a prior communication regime for the retail offers of the SMP operator. Both remedies would contribute to avoid the effective commercial launch of anticompetitive offers in the retail markets. If the NRA is empowered, either through ex ante provisions or by its specific national legislation, to monitor loyalty clauses, the final outcome could be further improved by facilitating consumer switching.