Body of European Regulators for Electronic Communications

BEREC

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BEREC Opinion on

Phase II investigation

pursuant to Article 7a of Directive 2002/21/EC as amended by Directive 2009/140/EC:

Cases EE/2013/1453-1454

Wholesale physical network infrastructure access at a fixed location (market 4) and wholesale broadband access (market 5) in Estonia

25 July 2013

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1. EXECUTIVE SUMMARY

On 13 May 2013, the Commission registered a notification by the Estonian national regulatory authority, Estonian Competition Authority (ECA), concerning the markets for wholesale physical network infrastructure access at a fixed location and wholesale broadband access corresponding to markets 4 and 5, respectively, in Commission Recommendation 2007/879/EC of 17 December 2007.

In both relevant markets, ECA had proposed to use a top down historical cost - fully distributed cost ("TD HC FDC") methodology for the calculation of prices for copper access, fibre access as well as wholesale broadband access.

On 13 June 2013, the Commission sent a serious doubts letter opening a phase II investigation pursuant to Article 7a of Directive 2002/21/EC as amended by Directive 2009/140/EC. The Commission's serious doubts relates to the lack of sufficient evidence supporting the choice of the costing methodology proposed by ECA.

On the basis of the analysis set out in this Opinion, BEREC considers that the Commission's serious doubts are justified.

BEREC therefore recommends that ECA adds to its SMP-decision a more thorough justification / evidence as to why, a TD HC FDC based costing methodology is to be preferred over a CCA based costing methodology, in the context of market 4 and market 5 services given the specific market situation in Estonia.

2. INTRODUCTION

On 13 May 2013, the Commission registered a notification by the Estonian Regulatory Authority, ECA, concerning the market for wholesale physical network infrastructure access at a fixed location and wholesale broadband access. On 24 May 2013, a request for information (RFI) was sent to ECA, and a response was received on 29 May 2013.

Subsequently, the Commission initiated a phase II investigation, pursuant to Article 7a of Directive 2002/21/EC as amended by Directive 2009/140/EC, by issuing a serious doubts letter to ECA on 13 June 2013. In accordance with the BEREC rules of procedure the Expert Working Group ("EWG") was established immediately after that date with the mandate to prepare an independent BEREC opinion on the justification of the Commission's serious doubts on the case.

On 21 June 2013, the EWG sent a first list of questions to ECA. A response was received from ECA on 25 June 2013. A second list of questions was sent on 25 June 2013 and a response was received on 26 June 2013.

The EWG met on 27 June 2013 in Stockholm. During this meeting, the EWG also met with ECA to gather further information and to seek clarifications in response to the questions sent the week before. In addition, some further questions were also raised by the EWG. The objective of the EWG is to reach a view on whether or not the Commission's serious doubts are justified.

A draft opinion was finalized on 15 July 2013 and a final opinion was presented and adopted by a majority of the BEREC Board of Regulators on 25 July 2013. This opinion is now issued by BEREC in accordance with Article 7a (3) of the Framework Directive.

3. BACKGROUND

Previous notifications

The market for wholesale (physical) network infrastructure access ("market 4") at a fixed location and the market for wholesale broadband access ("market 5") in Estonia were previously notified to and assessed by the Commission under case EE/2009/0942 and EE/2009/0943.

In market 4, ECA included in the relevant market for wholesale physical network infrastructure access the provision of local loops and sub-loops (including full and shared access) over copper and fibre, as well as access support services (including collocation, duct access and shared use of buildings). ECA concluded that the market was national, that Elion had significant market power (SMP) and it proposed the imposition of: (a) access; (b) transparency; (c) non-discrimination; (d) accounting separation; (e) cost accounting and cost-orientation obligations.

In market 5, ECA included in the relevant market all broadband access services provided over copper-based PSTN, fibre-optic infrastructures and coaxial cable networks. The relevant geographic market was found to be national in scope and Elion was designated with SMP and the following obligations were imposed on it: (a) access (at national, local and DSLAM level); (b) non-discrimination; (c) transparency (including a reference offer); (d) accounting separation; (e) and price control obligations.

The Commission issued comments on the definition of both relevant markets.

Current notification and the Commission's serious doubts

Market for wholesale (physical) network infrastructure access (including shared or fully unbundled access) at a fixed location (market 4)

ECA specified that market 4 includes both fibre-optic and copper-pair access services. The wholesale market also includes supporting services of access (including collocation, shared use of cable ducting and buildings) to the extent that such services are necessary for the use of wholesale services provided in the market of fixed access.

Wholesale broadband access market (WBA) (market 5)

ECA specified that market 5 includes broadband access services which are supplied or which can be supplied through a fixed electronic communications transmission network, a copper-pair based access network, a fibre-optic cable based access network and a coaxial cable network.

ECA´s reason for the inclusion of coaxial cable networks in the wholesale market is that, at least on a regional basis, broadband services provided at retail level on those networks are substitutable with broadband services provided over copper and/or fibre-optic access networks. ECA considers it theoretically possible to provide wholesale access on coaxial cable networks and that there is no objective reason to exclude cable technology in light of the requirement for sector-specific regulation to be technologically neutral.

The relevant geographic markets are both national.

Finding of significant market power

ECA has designated Elion as the SMP operator on both markets. The criteria used by ECA to assess SMP on these markets include: market shares, control of infrastructure not easily duplicated, absence or low countervailing buying power, structural barriers to entry (e.g. sunk costs, vertical integration), absence of potential competition, pricing and profitability.

Regulatory remedies

Market 4

ECA proposed the imposition of the obligation of access, non-discrimination, transparency and separate cost-accounting and cost-oriented fees on Elion.

With regard to price regulation, the SMP operator is requested to provide access to its copper pairs and fibre-optic (both in the feeder segment and in the access segment) at cost-oriented prices.

In relation to the proposed methodology to determine the cost oriented prices, ECA considers that the use of a simple TD HC FDC methodology is sufficient to avoid excessive prices and price discrimination. ECA indicated that this methodology has been used since 2007, which has resulted in a decrease to wholesale copper pair access prices.

ECA explained in the reply to the RFI that Elion is required to set and publish yearly its cost-oriented access rates (on the basis of the previous year's costs and volume), which will be controlled by ECA. The rates will be notified to the Commission. ECA further indicated that the wholesale rate for access to copper lines for 2013 is 5.21 EUR (below the 2012 rate, which was 5.48 EUR).

Furthermore, ECA stated that using this cost methodology will allow investors to cover the investment made and still make a profit.

Market 5

ECA proposed the imposition of the obligation of access, non-discrimination, transparency and separate cost-accounting and cost-oriented prices on Elion.

With regard to cost-accounting and cost-oriented rates, ECA proposed to abandon the previously imposed retail-minus price control methodology and to use instead a TD HC FDC price control methodology. ECA finds that the proposed cost-oriented price methodology serves to promote efficient and sustainable competition, while maximising consumer benefits and is suitable in a context where infrastructure is not easily duplicated. Furthermore, ECA argues that implementing such a methodology does not impose an undue burden on undertakings in the broadband access market, since there is no need to convert historical costs into current costs or to assess future costs. Furthermore, ECA states that using this cost methodology will allow investors to cover the investment made and still make a profit.

ECA further clarified that implementing Equivalence of Inputs (EoI) as a non-discrimination remedy would not be suitable in light of the small broadband lines volume of the SMP operator, as well as the workload and costs to the SMP operator and for the regulator, which would be unreasonable and disproportionate.

Serious doubts

Apart from commenting on ECA´s inclusion of coaxial cable networks in the relevant market 5, the Commission formed its serious doubts on the following issue:

- Lack of sufficient evidence supporting the choice of the costing methodology.

4. ASSESSMENT OF THE SERIOUS DOUBTS

On 13 June 2013, the Commission sent a serious doubts letter opening a phase II investigation pursuant to Article 7a of Directive 2002/21/EC as amended by Directive 2009/140/EC. The Commission's serious doubts relate to compliance with Articles 8(4) and 13(1) and (2) of the Access Directive in conjunction with Article 8 of the Framework Directive and Article 16(4) of the Framework Directive, in particular:

Serious doubts regarding the lack of sufficient evidence supporting the choice of the costing methodology

Concerns of the Commission

In its notification, ECA indicated there are different costing methodologies that can be used in order to set wholesale access rates on market 4 and on market 5. ECA came to the conclusion that a TD HC FDC is the most adequate model to be applied on both markets.

To reach this conclusion, ECA explained that: (i) a HC FDC price control methodology is less burdensome for the undertaking, compared to the other methodologies, since there is no need to convert historical costs into current costs (CC FDC) or to evaluate future costs (LRAIC); (ii) the incumbent (Elion) has implemented this methodology in market 4 since 2007, which has resulted in a price decrease; (iii) it ensures that the undertaking has not added unnecessary costs to the prices of services belonging to the wholesale market for fixed access; (iv) it allows the undertaking to obtain a reasonable profit, since the price calculated on the basis of the top-down price control methodology based on historical and fully distributed costs will remain exactly at the cost based level, showing the level of costs connected to the service, including fixed assets depreciation arising from investments, operating costs and capital costs, including reasonable profit; and (v) it benefits end-users, by reducing the danger of price squeeze that would be detrimental for the alternative operators, as well as reducing the prices at a retail level, thus contributing to the development of constant and effective competition in the market.

While the Commission recognises that the NRAs have a margin of discretion to propose a costing methodology to regulate access rates, the Commission specifies that any methodology has to be duly justified, in order to show that it fully complies with the policy objectives and regulatory principles of the Regulatory Framework, in particular Article 8 of the Framework Directive.

Against this background, the Commission has serious doubts that the proposed choice of costing methodology (HC FDC) complies with these regulatory principles. The Commission considers that the specific characteristic of this methodology, notably the use of historic costs for the valuation of all assets, can potentially lead to very low access prices. While historic cost models can ensure that the asset owner will be recovering its original investments, the eventual full depreciation of those assets, which have reached the end of their economic lifetime, will invariably lead to an important downward price trend over time.

In the Commission’s view, low copper access prices resulting from HC FDC models do not send the appropriate build or buy signals. Buying wholesale infrastructure or broadband access at rates which are much lower than the cost of rolling out the relevant infrastructure elements makes investments into parallel infrastructure economically unviable. This is likely to i) impede efficient investment and innovation in new and enhanced infrastructures, and ii) create obstacles, rather than removing them, to the provision of electronic communications services, since preventing investment from alternative operators deeper in the value chain would, over the medium to long term, lead to less infrastructure competition.

Beyond the negative effects on investment by alternative operators and competition on the legacy infrastructure, the Commission states that there are reasons to believe that lower copper access prices will also negatively impact investments in next generation access (NGA) networks and consequently competition thereon.

In a scenario where copper and fibre infrastructures are likely to co-exist, the low initial and potentially reduced copper access price over time resulting from the Estonian HC FDC model is unlikely to incentivise investments into NGA networks by the owner of the legacy infrastructure.

The Commission also noted that ECA proposes to impose the same HC FDC model to set the access price to Elion's FTTB and FTTH lines. In its serious doubts letter, the Commission stressed that, in principle, an NRA should lift cost orientation where Equivalence of Inputs (EoI) accompanied by technical and economic replicability requirements and constraints stemming from cost-oriented copper lines or infrastructure competition is in place.

While the Commission recognises that the HC FDC model used for setting the access rate to newly built infrastructure could, in principle, ensure the recoupment of investments, the Commission stated that it is unclear, based on the information provided by ECA, how the various assets are valued in the fibre model, what impact it might have on price developments over time, how a risk premium has been calculated and, ultimately, how the SMP operator will be compensated for its investment.

The Commission notes that ECA has motivated its choice of costing methodology with limited resources, and the ensuing wholesale and retail price decreases over time without sufficiently analysing at the same time the impact on the above key objectives of the Framework, such as to encourage investments by the operator, including in next generation networks, and to promote efficiency and sustainable competition and maximises consumer benefits.

The Commission stated that, taking into account the likely negative impact of the HC FDC model as proposed by ECA on investments of alternative operators and their ability to compete, as well as on the investments made by the incumbent operators, the Commission concludes that ECA has not sufficiently motivated that the proposed costing methodology fulfils the requirements of Articles 8(4) and 13(1) and (2) of the Access Directive, read in conjunction with Articles 8 and 16(4) of the Framework Directive and therefore raises serious doubts as to the compatibility of the proposed draft measure with EU law.

The Commission believes that the application of the HC FDC method as proposed by ECA is likely to prevent the establishment and development of a trans-European network, thus creating barriers to the single market. Specifically, multi-national operators intending to invest in the Estonian network infrastructure access and broadband markets are likely to be deterred by the limited investment returns in light of the applied wholesale and prospective retail rates.

Therefore, the Commission concluded that at the current stage of the procedure, and on the basis of the information available, the Commission has serious doubts as to the compatibility of the costing methodology remedy proposed by ECA with EU law and consider that this remedy creates barriers to the internal market.

BEREC's Assessment

Legal basis of the investigation

According to Article 8(4) of the Access Directive (AD), obligations imposed shall be based on the nature of the problem identified, proportionate and justified in the light of the objectives laid down in Article 8 of the Framework Directive (FD).

According to Article 13(1) AD, an NRA may impose obligations relating to cost recovery and price controls so as to encourage investments by the operator, including in next generation networks, where the national regulatory authorities shall take into account the investment made by the operator, and allow him a reasonable rate of return on adequate capital employed, taking into account any risks specific to a particular new investment network project.

According to Article 13(2) AD, NRAs shall ensure that any cost recovery mechanism or pricing methodology that is mandated serves to promote efficiency and sustainable competition and maximise consumer benefits.

According to Article 7(2) FD, NRAs shall work with the Commission and BEREC to identify the types of instruments and remedies best suited to address particular types of situations in the marketplace.

According to Article 7(3) FD, NRAs shall make the draft measure accessible to the Commission, BEREC, and the national regulatory authorities in other Member States, together with the reasoning on which the measure is based.

BEREC's assessment

In this case, the Commissions serious doubts concern the lack of justification for the costing methodology (TD HC FDC) chosen by ECA. Therefore, BEREC has assessed whether the justification in ECA's draft measure notified to the Commission, as well as its response to the RFI, are sufficient. It should be stressed that the issue at stake in this case is therefore not whether ECA can reach the regulatory objectives by using a TD HC FDC methodology. For this reason BEREC refrains from assessing whether or not specifically a TD HC FDC approach is the most appropriate in the given case.

BEREC's assessment of the serious doubts

BEREC notes that NRAs need to take into account the objectives set in Article 8 FD. The Access Directive gives the NRA discretion when deciding how best to apply the available regulatory tools in the pursuit of these objectives. In the opinion of BEREC it is therefore important to determine for each individual case which remedy is to be imposed, taking into consideration the specific circumstances and ensuring that the proposed remedies are proportionate to the identified problem.[1] Therefore, the decision on the type of costing methodology to implement lies within the authority of the NRA, as long as it complies with the regulatory framework.

ECA has proposed to use a TD HC FDC model as the pricing methodology for setting the prices for copper access, fibre access as well as wholesale broadband access services. ECA´s motivation for the choice of methodology is that implementation of a TD HC FDC price control methodology is less burdensome for the undertaking compared to the price control methodologies based on CC FDC or LRAIC. Furthermore, the SMP operator has used the named methodology in the wholesale copper-pair access market since 2007 and its wholesale copper-pair access prices have decreased as a result. Finally, ECA is also of the view that the methodology ensures that unnecessary costs are not included in the prices of services, it allows the undertaking to obtain a reasonable profit, and it benefits end-users by reducing the danger of price squeeze. In ECA´s opinion, such a methodology is adequate for avoiding excessive prices and price discrimination.[2] In conclusion, ECA does not see the need to implement a CC FDC or a LRAIC price control methodology on the SMP operator and finds that use of a TD HC FDC methodology is sufficient.

In its response to the Commission´s RFI on 24 May 2013, ECA further elaborated on the motivation of a TD HC FDC methodology by referring to the impacts of the economic situation in Estonia and the fact that the Estonian wholesale network infrastructure access market is very small - enacting that disproportionate and burdensome remedies on the SMP operator might decrease investments.

Based on BEREC's assessment of the serious doubts case initiated by the Commission on ECA, BEREC finds that ECA´s reasoning for using a TD HC FDC methodology, provided in the documentation presented to the Commission, is not sufficient to allow the Commission and BEREC to judge whether or not the chosen pricing methodology is the one best suited to address the particular situation in the Estonian marketplace.

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[1] See for example BEREC opinions on Art. 7a Phase II cases LV/2012/1296 (BoR (12) 28) p.11 and PL/2012/1311 (BoR (12) 66) p.9.

[2] P. 423 and 424 of the draft SMP-decision on market 4.

Hence, BEREC shares the Commission´s serious doubts that ECA, in the light of the objectives laid down in Article 8 of the FD, has not sufficiently justified whether the proposed costing methodology fulfils the requirements of the regulatory framework.

Based on the information presented by ECA to the Commission, BEREC is not able to determine whether the costing methodology suggested by ECA (TD HC FDC) deters efficient investments and innovation as suggested by the Commission. Further, it is not clear to BEREC whether the suggested costing methodology prevents investments from alternative operators and thereby hampers infrastructure competition as also suggested by the Commission. In order for the Commission and BEREC to be able to assess whether the costing methodology preferred by ECA is the one best suited to address the competition problems in Estonia and the overall regulatory objectives, ECA should provide adequate justification / evidence on how and why it has come to this conclusion. BEREC agrees with the Commission that this justification should at least include:

- Assessment of build-or-buy signals resulting from the chosen methodology, especially in terms of alternative operators' investments in legacy and NGA networks and their ability to compete; and
- Assessment of the impact of the chosen methodology on the SMP operator's investments in NGA networks and competition thereon.

These could be further strengthened by including the following arguments and data in the justification:

- Competition assessment of market 4 and market 5 (see guidance in Figure 3 of BEREC's report BoR (11) 65);[3]
- Assessment of asset replicability (see BEREC report (BoR (11) 65));
- Details on how the SMP operators investment plans over the next few years have been factored into the wholesale access prices set;
- Size of the relevant wholesale markets;
- A cost – benefit analysis of implementing CC FDC or LRAIC based costing methodologies that compares the cost of this implementation with the expected benefits, for example with regard to increased investment and consumer benefit.

BEREC generally shares the view of the Commission, that in certain market situations the orientation on the efficient build-or-buy signal is best suited to achieve the aims of the Framework Directive and ensures appropriate incentives for infrastructure investment. In its report BoR (11) 65, BEREC showed, that an undistorted build-or-buy signal is best achieved by implementation of a CCA based cost accounting system. However, BEREC also identified some market situations, where other methods of cost-orientation (or price regulation in general), including HCA, may be better suited. The decision on the type of costing methodology to implement therefore depends largely on national circumstances. BEREC also notes that the Commission has previously approved without comments the use of TD HD FDC in Estonia, and the methodology has been in use already since 2007 in the wholesale copper-pair access market.

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[3] BEREC response to the Commissions Questionnaire on costing methodologies for key wholesale access prices in electronic communications.

In particular, BEREC would like to point out that there is already some data included within ECA's draft decisions, which does not support the Commission's view that the Estonian price level has negative effects on investment by alternative operators. Specifically table 9 in the draft decision on market 4 indicates that investment in NGA by alternative operators does take place. In fact, it seems that NGA investment is very well on its way in Estonia. However, ECA has not used any data regarding investments in the justification of the chosen price control methodology.

In its letter, the Commission makes several statements questioning the ability of the chosen methodology, TD HC FDC, to reach the regulatory objectives, statements which can be challenged. BEREC will limit its comments to the following issues.

BEREC questions the Commission's statement that HCA could lead to copper access prices, which are too low to compensate the incumbent operator for the maintenance of the network infrastructure. In an HCA based methodology, costs for maintenance are generally included.

BEREC would also like to highlight the point raised by the Commission on ECA´s proposed price regulation of fibre, where the Commission stated that, in principle, an NRA should lift cost orientation where Equivalence of Inputs (EoI) is in place. However, BEREC would like to point out that according to point 25 of the NGA-recommendation, in force since 2010, the price of access to the unbundled fibre loop should be cost-oriented. BEREC therefore finds it odd that the Commission´s statement deviates from the NGA-recommendation, and instead relies on the draft Commission recommendation on non-discrimination and costing methodologies, which was not formally adopted by the Commission at the time of ECA´s notification.

5. CONCLUSIONS

On the basis of the assessment set out in section 4 above, BEREC considers that the Commission's serious doubts regarding the draft decision of the Estonian NRA, ECA, on lack of sufficient evidence supporting the choice of the costing methodology - as expressed in the Commissions letter to ECA of 13 June 2013 – are justified.

BEREC is of the opinion that ECA´s reasoning for using a TD HC FDC methodology is not sufficient to allow the Commission and BEREC to judge whether or not the chosen pricing methodology is the one best suited to address the particular situation in the Estonian marketplace.

In order for BEREC to be able to assess whether the costing methodology preferred by ECA is the one best suited to handle competition problems in Estonia, ECA must provide more adequate justification / evidence as to why it has come to this conclusion.

BEREC therefore recommends that the ECA adds to its SMP-decision a more thorough justification / evidence as to why, a TD HC FDC based costing methodology is to be preferred over a CCA based costing methodology, in the context of market 4 and market 5 services given the specific market situation in Estonia.