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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:

Case ES/2013/1466

Review of wholesale broadband access prices (market 5)

in Spain

05 August 2013

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1. EXECUTIVE SUMMARY

On 27 May 2013[1], the Commission registered a notification from the Spanish national regulatory authority, Comisión del Mercado de las Telecomunicaciones (CMT), concerning the review of prices in the market for wholesale broadband access corresponding to market 5 in Commission Recommendation 2007/879/EC of 17 December 2007.

In the notified decision, CMT proposes prices for market 5 services with reference to a) the results of a bottom-up long run incremental cost (BU-LRIC+) model; b) Telefónica's[2] cost accounting results and c) a benchmark of regulated prices in chosen Member States. In addition, when determining the price for the new regulated NEBA fibre-based service, CMT includes an analysis based on the retail-minus methodology to set the maximum value which the fibre-based access rate cannot exceed.

On 27 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 CMT's choice of price regulation applied in market 5.

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

BEREC recommends that CMT adds to its tariff decision a justification on the price regulation applied for market 5 services to safeguard the transparency of the decision making process with regard to setting the price levels. This could, e.g., entail an analysis of the appropriateness of all criteria and their weights being used to determine the resulting price levels, an impact assessment of the proposed prices on (the balance between) competition, investments and consumer benefits, and/or a reconciliation with cost calculations based on the SMP operator´s accounts (or expectations).

2. INTRODUCTION

On 27 May 2013, the Commission registered a notification from the Spanish national regulatory authority, Comisión del Mercado de las Telecomunicaciones (CMT), concerning the review of prices in the market for wholesale broadband access (market 5). On 6 June 2013, a request for information (RFI) was sent to CMT, and a response was received on 11 June 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 on 27 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

[1] On the same date, CMT also notified a review of prices in the market for wholesale (physical) access at a fixed location (market 4), case ES/2013/1465. As the Commission's serious doubts do not relate to market 4, this case is not part of this BEREC Opinion.
[2] Telefónica de España, S.A.U.

prepare an independent BEREC opinion on the justification of the Commission's serious doubts on the case.

On 4 July 2013 the EWG sent a list of questions to CMT. A response was received from CMT on 8 July 2013.

The EWG met on 9 July 2013 in Den Haag. During this meeting, the EWG also met with CMT 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 was to reach clear conclusions on whether or not the Commission's serious doubts are justified.

A draft opinion was finalized on 29 July 2013 and a final opinion was presented and adopted by a majority of the BEREC Board of Regulators on 5 August 2013. This opinion is now issued by BEREC in accordance with Article 7a (3) of the Framework Directive.

3. BACKGROUND

Previous notifications

The last full review of the market for wholesale broadband access at a fixed location in Spain was notified to and assessed by the Commission under case ES/2008/805. The Commission had serious doubts concerning a) the exclusion of high speed access (above 30 Mbit/s) from the market definition; b) the inclusion of LLU and TV cable in the relevant market, and c) the extent to which the different competitive conditions would point towards geographic segmentation of the market. Following CMT's amendments of the measure the Commission withdrew its serious doubts, commented, however, on the non-imposition of regulatory measures with regard to bitstream products with speeds above 30 Mbit/s.

A subsequent notification assessed by the Commission under case number ES/2011/1194 proposed an increase in the regulated bitstream price. The Commission raised concerns in its comment about the lack of transparency of CMT's decision making procedure. Under notification ES/2013/1433 CMT proposed a revised methodology for the *ex-ante* analysis of Telefónica's commercial offers, as well as of certain communication obligations. The Commission commented on the need to conduct a new market review, and highlighted that it is working towards the adoption of a Recommendation on the consistent application of non-discrimination obligations and costing methodologies, which will give some guidance on the design of an *ex ante* economic replicability test for NGA-based services, when such services is not subject to price control obligations.

Current notification and the Commission's serious doubts

This notification relates to measures to implement obligations imposed in CMT's SMP-decision regarding market 5, notified to the Commission under case ES/2008/805. In that decision CMT has imposed cost-orientation of prices for wholesale broadband access. The method to be used for setting cost-oriented prices is subject to a set of additional requirements. In particular, CMT has emphasized the objectives of ensuring sufficient economic incentives for the development of alternative networks, and guaranteeing the consistency of prices of wholesale services. In its response to the Commission's RFI, CMT outlined that in its price revisions, prices do not necessarily need to be aligned with actual cost calculation results, but rather corrected by means of the application of a certain additional margin or mark-up. The corrections aim to set prices above cost results and to avoid excessively low access prices which may dis-incentivise the implementation of unbundled access.

In the notified decision, CMT proposes to set the prices with reference to a) the results of a bottom-up long run incremental cost (BU-LRIC+) model[3]; b) Telefónica's cost accounting results and c) a benchmark of regulated prices in chosen Member States. In addition, when determining the price for the new regulated NEBA fibre-based wholesale broadband access service, CMT applies a retail-minus approximation based on Telefónica's retail offer 'Movistar Fibre' which offers 100Mbit/s downlink and 10 Mbit/s uplink.

Serious doubts

Apart from commenting on the need to conduct a new review of market 5 as soon as possible, the Commission has serious doubts as to the compatibility of CMT's draft measures with EU law and considers that they create barriers to the single market. Specifically, the Commission expresses serious doubts concerning the lack of sufficient evidence supporting the choice of the price regulation applied in the wholesale broadband access market.

4. ASSESSMENT OF THE SERIOUS DOUBTS

On 27 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 concern compliance with Articles 13(1) and 13(2) of the Access Directive in conjunction with Articles 3(3), 8(5) a), 8(5) c) and 8(5) d) of the Framework Directive, in particular:

Serious doubts regarding the lack of sufficient evidence supporting the choice of the price regulation applied in the wholesale broadband access market.

Concerns of the Commission

While the Commission recognises that the NRAs have a margin of discretion in proposing a costing methodology to regulate access rates, the Commission underlines 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. The Commission understands the price setting methodology in market 5 to include an element of arbitrariness, in particular since the proposed prices cannot be traced back to the cost model or Telefonica's accounts.

[3] CMT has developed a new BU-LRIC+ model, which estimates the monthly costs incurred by an efficient operator for providing unbundled loop services throughout Spain.

While the Commission does not put into question the objectives CMT set out in its SMP-decision, the price setting methodology proposed by CMT in the notified measures raises serious doubts as to the compatibility with EU law, in particular with the following provisions:

a) Compliance with Article 8(5) c) of the Framework Directive and Article 13(2) Access Directive which stipulate that NRAs shall safeguard competition to the benefit of consumers, and promote efficiency and sustainable competition;

The Commission has serious doubts that by setting price levels for the NEBA service, but also for bitstream legacy products (GigADSL and ADSL-IP) up to 50% above cost-efficient levels, CMT is safeguarding and promoting competition on the Spanish broadband markets.

In particular, the Commission notes that the NEBA fibre product is the only available regulated wholesale service over fibre infrastructure in the Spanish market. The Commission believes that CMT has not submitted sufficient evidence to show that its regulatory approach favours competition in broadband services as: a) CMT proposes to implement a 33% upward adjustment to the NEBA fibre price resulting from the costing model which already takes into account a 4.81% fibre risk premium, b) FTTH infrastructures are not regulated as part of market 4, and c) regulation of bitstream services is limited to speeds up to 30Mbit/s.

b) Compliance with Article 8(5) d) of the Framework Directive which stipulates that NRAs shall promote efficient investment and innovation, whilst ensuring that competition in the market is preserved;

The Commission has serious doubts that the proposed prices incentivize efficient investments and innovation, both by the SMP operator and the alternative operators. The Commission points out that an *ex ante* price control obligation for fibre infrastructure would not be necessary if there were sufficient competition safeguards in place. To that purpose, the Commission stresses that, in principle, an NRA should not impose regulated wholesale access prices, where a strict non-discrimination obligation (i.e. Equivalence of Inputs (EoI), which generally requires SMP operators' own downstream operations to use the same products, processes, and prices as those used by their retail competitors) accompanied by other competitive safeguards (such as a technical and economic replicability requirement for fibre-based retail products, demonstrable retail price constraints stemming from cost-oriented copper lines or infrastructure competition) is in place.

In respect to the analysed notification, the Commission notes that even though CMT's goal is to incentivize investments, it decides not to consider the possibility of implementing the approach outlined above, but instead decides to regulate wholesale broadband access prices by setting them above the cost level, taking into account SMP operator's cost accounting results and prices in other Member States.

The Commission considers that the proposed measures will fail to ensure economic incentives for any operator to invest, be it the SMP operator or an access seeker. If CMT would, when analysing the market, come to the conclusion that cost-orientation would not be the appropriate measure in order to spur investment and increase competition, the Commission believes that CMT, rather than adding arbitrary mark-ups to the cost-oriented results, should assess whether an approach with a stricter non-discrimination obligation, as set out above, would be appropriate and in that case allow for the lifting of cost-orientation when the right competitive safeguards are in place.

Regarding the SMP operator, price regulation with prices set arbitrarily and well above costs, may not allow the testing of price points and create differentiated offers in order to stimulate demand for new NGA services. As for alternative operators, proposed prices are not sending the correct "build or buy" signal since they are not based on the efficient costs of providing the services and as such risk being detrimental to operators seeking bitstream access, which may function as a stepping stone towards further investments in the access seeker's core network and the eventual purchasing of market 4 access (ladder of investment principle). Further, in the absence of any regulation of the SMP operator's fibre network in the upstream market 4, excessively high prices for the NEBA fibre bitstream risk foreclosing access seekers from the NGA network altogether and thus remonopolize the market for high-speed broadband services, thus not ensuring that competition is preserved.

c) Compliance with Article 8(5) a) of the Framework Directive according to which NRA's shall promote regulatory predictability by ensuring a consistent regulatory approach over appropriate review periods;

The Commission has serious doubts that in departing from setting prices on the basis of the developed model CMT ensured predictability for all market players. Knowing that CMT has developed a BU-LRIC+ cost model, stakeholders most likely had legitimate expectations that the prices will be set on the basis of the model. The deviation in market 4 does not raise serious doubts that such legitimate expectations would be at risk, whereas in market 5 this is a concern. Moreover, by not indicating when the prices will be set according to the cost model CMT introduced an additional element of uncertainty.

Moreover, in the Commission's view the reference to prices in other Member States (on top of cost accounting results) adds to the lack of clarity and predictability of the notified draft measure. First of all, as the Commission repeatedly held, benchmarking is not a suitable price setting methodology, as it is unreliable to compare bitstream service prices among Member States for various reasons, one being the fact that such an approach does not take into account specificities of the price levels and structure in the national market, to ensure, as CMT repeatedly points out, price consistency between different access products. Further, benchmarking bitstream products tends to be complex since the price structure varies across Member States, which CMT also notes in their draft measure. Secondly, in this case, when setting the NEBA fibre price, CMT not only took into account bitstream prices, but also prices for fibre unbundling and VULA products in other Member States. More importantly, there is no indication that the comparison took into consideration the fact that the wholesale broadband access price in Spain will only apply to services up to 30Mbit/s. Finally, given that CMT has a BU-LRIC+ model in place, the use of benchmark is particularly problematic.

Further to that, the Commission is of the view that similar arguments apply to CMT's decision to additionally apply a retail-minus approximation for fibre NEBA, by comparing the wholesale product offered by Telefónica to its retail offers which offers speeds of 100Mbit/s. Again, the Commission is of the view that the stakeholders could not predict that CMT will, in addition to adjusting the cost model price by taking into account cost accounting results and prices imposed in other Member States, add another layer of uncertainty by applying the retail-minus method.

d) Compliance with the principle of transparency according to which NRAs should exercise their powers impartially, transparently and in a timely manner;

The Commission notes that CMT explains in its draft measure, which regulatory objectives - the need to incentivize investments and the need to insure consistency of wholesale prices - have prompted it to depart from the cost model results.

According to Article 3(3) of the Framework Directive, national regulatory authorities should exercise their powers impartially, transparently and in a timely manner. In relation to this, the Commission points out that the draft measures do not contain a clear indication of the methodology CMT followed in order to set the proposed price, apart from explaining that the price needs to be adjusted upwards; however the specific percentage of this adjustment has been chosen on the basis of criteria not so clearly elaborated.

This might create the impression that prices were at certain instances set arbitrarily and without any methodological rigour, thus the Commission has serious doubts that the approach taken by CMT complies with the principle of transparency. The Commission also highlights that due to the fact that the last market review was made in 2008, that FTTH and bitstream services above 30Mbit/s are not regulated, CMT has also not provided any reasoning as to why its previous approach, which imposed little or no regulation on fibre, was insufficient.

BEREC's Assessment

Introductory remarks

Before assessing the concerns raised by the Commission in its letter, BEREC finds it necessary to make a few remarks that are relevant for this case.

First, BEREC notes that the latest full review of market 5 was completed in 2008. In the resulting SMP-decision of January 2009, CMT imposed a set of remedies on the SMP operator. This decision was notified to and assessed by the Commission under case ES/2008/805. The decision currently under review is an implementation of the SMP-decision of 2009. Therefore, it is BEREC's view that the choices made in the SMP-decision of 2009, including the set of remedies imposed, are currently not under review. The Commission's serious doubts and BEREC's assessment thereof can only concern the question whether CMT has properly implemented the remedies imposed in 2009.

Secondly, BEREC understands that in 2011, CMT notified a decision[4] to the Commission which contained the same price setting ('markup') methodology as CMT used in the decision currently under review. In the 2011 case, the Commission did not express any serious doubts or did not make any comments on the methodology used by CMT. As there have been no changes in the regulatory framework in the period between the two notifications, BEREC understands that the opening of a phase II investigation for this case may have come unexpected for CMT and other stakeholders.

Thirdly, BEREC notes that NRAs need to take into account the objectives set in Article 8 of the Framework Directive. The Access Directive gives the NRA discretion when deciding how

[4] Case number ES/2011/1194.

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 and how it should be implemented, taking into consideration the specific national circumstances and ensuring that the imposed remedies are proportionate to the identified problem.[5] Therefore, the decision on the type of pricing methodology to implement lies fully within the authority of the NRA, as long as it complies with the regulatory framework.

Assessment of the serious doubts

In its serious doubts letter, the Commission recognizes that NRAs have a margin of discretion in proposing a costing methodology to regulate access rates. The Commission also underlines 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. BEREC fully agrees with the Commission and refers to the third introductory remark in the previous section. In BEREC's view, CMT may choose to deviate from strict cost-orientation as long as CMT can properly justify this choice.

In its SMP-decision of 2009, CMT set out the objectives which should be taken into account when adjusting the cost-oriented price for wholesale broadband access services. The Commission does not put these objectives into question. BEREC agrees with the Commission that there is no reason to question the objectives set by CMT. Referring to the first introductory remark in the previous section, BEREC is also of the opinion that these objectives are not subject to review in this case.

The serious doubts of the Commission concern the price setting methodology proposed by CMT. BEREC shares the Commission's view that CMT has not submitted sufficient evidence to support the choice of this methodology. It is not clear to BEREC if the objectives set in Article 8 of the Framework Directive, and the objectives set by CMT in its 2009 decision, will be reached by the methodology CMT is proposing. Although an NRA may choose to deviate from the cost-oriented result, CMT has not provided sufficient justification on the necessity and size of that deviation. From a wide range of possible outcomes, CMT has chosen a specific price level without providing a rationale for that choice.

For example, in the notified decision CMT defines a range of possible outcomes for the NEBA fibre access monthly fee between 14,87 euro (cost model) and 20,24 euro (retail minus maximum fee). From that range CMT identifies 20 euro as the balance point between the objectives of promoting competition by means of the NEBA service itself and keeping incentives for the development of alternative networks. However, CMT does not provide any calculation or other justification why 20 euro is the right balance point. Although CMT states that its price setting methodology is directly linked to objectives relating to safeguarding and promoting competition, investment and consistency, the decision does not show that link.

BEREC also notes that in its comments on CMT's draft measure[6], the Spanish National Competition Commission, CNC, questions whether the chosen methodology is effective for the purposes proposed, and how it can affect the development of effective competition in the relevant markets. CNC observes that it cannot rule out that these high wholesale prices reduce the capacity and incentives of operators to invest in new generation networks and

[5] E.g. BEREC opinion Art 7a Phase II Case LV/2012/1296 (BoR(12)28)
[6] Draft measure on GigADSL, ADSL-IP and NEBA broadband wholesale service prices, section 5.

that these prices could lead to a reduction in the competitive pressure of alternative operators, which could in turn harm consumers in the form of higher prices and worse service.

It is BEREC's view that, in general but especially when complementing cost orientation with other criteria, CMT should seek to minimize the arbitrary element in its methodology and properly justify the price levels it sets. This justification could, e.g., entail an analysis of the impact of the proposed prices on (the balance between) retail market competition, investments and consumer benefits (which could also provide valuable insights in the consequences of deviating from the cost-efficient prices calculated by the BU-LRIC+ cost model). It could also include a reconciliation with cost calculations based on the SMP operator´s accounts (or expectations in case of relatively new services), in particular when CMT is not convinced that the cost model provides reliable and stable results.

BEREC notes that the Commission points out that an ex ante price control obligation for fibre infrastructure would not be necessary if there were sufficient competition safeguards in place. With reference to the first introductory remark in the previous section, BEREC is of the opinion that the Commission's serious doubts and BEREC's assessment thereof can only concern the question whether CMT has properly implemented the remedies it imposed in its SMP decision of 2009. Hence, the Commission's remarks on a change in the set of remedies are not relevant in the current case. Furthermore, the approach the Commission is proposing relies on the draft Commission recommendation on non-discrimination and costing methodologies, which was not formally adopted by the Commission at the time of CMT´s notification.

The Commission also expressed serious doubts that, in departing from setting prices on the basis of the developed model, CMT ensured predictability for all market players. According to the Commission, stakeholders most likely had legitimate expectations that the prices would be set on the basis of the model.

BEREC does not share this view. CMT did not impose a strict cost-orientation obligation, but an obligation that allowed adjustments to cost-oriented results to meet certain objectives. The cost orientation obligation, including the additional requirements affecting the interpretation of the obligation, has been in force since 2009. In subsequent tariff decisions in 2009 and 2011, CMT has implemented this obligation by making adjustments to the cost-oriented results. Hence, it is unlikely that stakeholders were expecting CMT to set prices based on calculations from the BU-LRIC+ model alone, since this would have required another wording of the pricing obligation. In BEREC's view, CMT's deviation from the results of the cost model was predictable for stakeholders.

BEREC generally agrees with the Commission's remarks in the context of the current market 5 case on the use of benchmarking when setting prices. However, BEREC would like to emphasize that in CMT's case the precise impact of the benchmarking results is unclear, but seems to be mostly limited to a check of the reasonableness of the proposed prices.

5. CONCLUSIONS

On the basis of the economic analysis set out in section 4 above, BEREC considers that the Commission's serious doubts regarding the draft decision of the Spanish NRA, CMT, on the lack of sufficient evidence supporting the choice of the price regulation applied in the wholesale broadband access market (market 5) - as expressed in the Commission's letter to CMT of 27 June 2013 – are mostly justified.

BEREC agrees with the Commission that CMT has not provided a transparent and sufficient justification that the price levels it set in the notified decision will reach the objectives of the regulatory framework and the objectives of CMT's own market analysis decision. However, BEREC does not agree with the Commission that stakeholders could not predict that CMT would deviate from the results of the BU-LRIC+ cost model.

In the light of the Commission's serious doubts and the argumentation above, BEREC would recommend CMT to add to its tariff decision a justification on the price regulation applied for market 5 services to safeguard the transparency of the decision making process with regard to setting the price levels. This could, e.g., entail an analysis of the appropriateness of all criteria and their weights being used to determine the resulting price levels, an impact assessment of the proposed prices on (the balance between) competition, investments and consumer benefits, and/or a reconciliation with cost calculations based on the SMP operator´s accounts (or expectations).