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:

Case LV/2014/1538

Wholesale voice call termination on individual fixed networks (market 3) in Latvia

14 March 2014

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1. EXECUTIVE SUMMARY

On 2 January 2014, the Commission registered a notification by the Latvian Regulatory Authority, Sabiedrisko Pakalpojumu Regulēšanas Komisija (SPRK), concerning remedies in the markets for fixed call termination in Latvia.[1]

SPRK proposes to set new price caps for fixed termination rates in Latvia for all SMP operators under a two part tariff structure: call set-up fee and per minute fee. SPRK uses an international benchmarking against European Union countries which have notified and adopted pure BU-LRIC FTRs as of September 2013, in order to set the per minute fee. SPRK also proposes to set a call set-up fee based on the actual call set-up costs of Lattelecom ltd. for 2012, after discounting them with the relative difference between the per minute rates currently in place and the newly proposed per minute rates (resulted from the above-mentioned benchmark).

On 3 February 2014, 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. Commission's doubts concern incorrect implementation of benchmarking with regard to fixed termination rates (FTRs).

On the basis of the economic analysis set out in this Opinion, BEREC considers that the Commission's serious doubts are justified in that a flaw in SPRK's proposed benchmarking methodology to set FTRs departs from the TR Recommendation[2] without valid justification. In addition, BEREC notes that not considering all of the countries with a pure BU-LRIC FTR has a non-trivial impact on the result of the SPRK's benchmarking, artificially inflating the perceived difference between Latvian rates and average pure BU-LRIC FTRs in other Member States.

On the other hand, BEREC has taken the view SPRK's proposal could in principle create some barriers to the internal market, but that any such barriers are likely to be of reduced magnitude.

BEREC recommends that SPRK addresses the methodological flaw and consider revising the benchmark to the earliest convenience possible, so that FTR levels in Latvia are set in accordance with the TR Recommendation as soon as possible.

2. INTRODUCTION

On 2 January 2014, the Commission registered a notification by SPRK, concerning remedies in the markets for fixed call termination on individual public telephone networks at a fixed location (corresponding to market 3 in Commission Recommendation 2007/879/EC of 17 December 2007) in Latvia. On 15 January 2014, a request for information (RFI) was sent by the Commission to SPRK, and a response was received on 20 January 2014.

[1] At the same time, SPRK also notified modification of remedies on the markets for call termination on individual mobile networks in Latvia. The serious doubts do not concern this market.

[2] Commission Recommendation no. 396 of 7 May 2009 on the Regulatory Treatment of Fixed and Mobile Termination Rates in the EU.

The Commission initiated a phase II investigation, pursuant to Article 7a of Directive 2002/21/EC as amended by Directive 2009/140/EC, with a serious doubts letter on 3 February 2014. 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 6 February 2014 the EWG sent a first list of questions to SPRK. Answers were received from SPRK on 10 February 2014. A second list of questions was sent on 10 February 2014 and SPRK answered on 14 February 2014.

The EWG met on 12 February 2014 in Bucharest. During this meeting the EWG held a meeting with SPRK to gather further information and clarification arising from the response received to the above questions and to additional questions. The main objective of the EWG meeting was to reach clear conclusions on whether or not the Commission's serious doubts are justified.

A draft opinion was finalized on 7 March 2014 and a final opinion was presented and adopted by a majority of the BEREC Board of Regulators on 14 March 2014. This opinion is now issued by BEREC in accordance with Article 7a (3) of the Framework Directive.

3. BACKGROUND

Previous notifications

The third review of the markets for call termination on individual public telephone networks provided at a fixed location ("market 3") in Latvia was notified to and assessed by the Commission under the case N° LV/2011/1199.

In July 2012, SPRK notified the modification of remedies on market 3. The assessment of this draft measure by the Commission led to the opening of a second phase investigation.

The Commission expressed serious doubts given that the top-down fully distributed cost methodology proposed by SPRK to set FTRs did not ensure that termination rates were set on the basis of the cost of an efficient operator and, therefore, did not ensure the promotion of efficiency and sustainable competition and the maximisation of consumer benefits. SPRK withdrew its notification of the draft measure on 17 August 2012.

Current notification

In the currently notified draft measures concerning the modification of remedies, SPRK proposed to set price caps for fixed termination services of all the operators which have been previously designated as having SMP.

SPRK made use of an approach based on international benchmarking to derive maximum FTR levels.

SPRK carried out the benchmark analysis covering the period up to September 2013 and included all countries that had adopted FTRs based on a pure BU-LRIC methodology by that time.

SPRK indicated that this approach delivered outcomes consistent with the requirements of the TR Recommendation, although it is currently not in a position to develop its own pure BU-LRIC model.

SPRK specified in the public consultation document that the arithmetic average rate in those European Union countries that had notified the Commission of their proposed fixed call termination rates, using a pure BU-LRIC cost model, is EUR 0.000785 per call minute.

SPRK proposes in the draft measure to fix, as of 1 July 2014, the FTR caps, excluding value added tax, at a one-off fee of EUR 0.000845 per call[3] and EUR 0.000785 per call minute.

SPRK also proposes that the relative decrease in the proposed value of the one-off fee per call corresponds to the proposed relative reduction of the per minute FTR (i.e. is proportionately equal to the reduction of the proposed rate per minute determined by the use of benchmarking).

Commission's serious doubts

Apart from inviting SPRK to develop its own pure BU-LRIC model for fixed and mobile termination rates and commenting on the entry into force of pure BU-LRIC fixed and mobile termination rates, the Commission expressed its serious doubts on the following issue:

Incorrect implementation of benchmarking with regard to FTRs

Compliance with Articles 8(4) and 13(2) of the Access Directive in conjunction with Article 8 of the Framework Directive and Article 16(4) of the Framework Directive

The Commission observed that SPRK proposed to set FTRs on the basis of a benchmark against other Member States which apply the pure BU-LRIC methodology. SPRK set its rate on the basis of the arithmetic average of the FTRs calculated by NRAs in France, Italy, Malta, Slovakia, Ireland and the Netherlands. However, the Commission also noted that SPRK decided to allow the fixed network operators to charge an additional fee – call set-up fee, which is added on top of the per minute fee derived from the benchmarking.

The Commission observed that, despite significant decreases, the proposed rates are significantly above the average costs derived from the pure BU-LRIC benchmarking.

The Commission further considered that SPRK did not provide a sufficient justification showing that the proposed methodology would equally allow promoting efficiency and sustainable competition and maximise consumer benefits in line with the policy objective and principles of the Regulatory Framework (Articles 8(4) and 13(2) of the Access Directive in conjunction with Article 8 of the Framework Directive and Article 16(4) of the Framework Directive). Moreover, SPRK did not provide any justification for the additional fees over and above the benchmarked (average) pure BU-LRIC FTRs. In that regard the Commission noted that the application of a two part tariff, consisting of a fixed fee (call set-up) and a

[3] Also referred to as call set-up fee or fixed fee

variable part (per minute fee) is not uncommon in relation to the fixed termination services. Nevertheless, according to the Commission, the SPRK should have ensured that the total costs of call termination in the fixed networks in Latvia correspond to the pure BU-LRIC costs in the benchmarked Member States, and not only a part of it.

Creation of barriers to the internal market

The Commission noted that due to the methodological flaws of the benchmarking, the proposed FTRs will remain (for undetermined period of time) significantly higher in Latvia than the average FTRs in those Member States which set the rates on the basis of pure BU-LRIC model.

According to the Commission, any such considerable differences in FTRs within the EU not only distorts and restricts competition but also has a significant detrimental effect on the development of the internal market, i.e. creates a considerable barrier to the single market, and, therefore, result in a violation of the principles and objectives of Article 8(2) and (3) of the Framework Directive.

The Commission considers that a harmonised approach in setting FTRs is particularly important to ensure that regulators do not favour their national operators at the expense of operators in other Member States by not introducing fully cost-oriented termination rates.

4. ASSESSMENT OF THE SERIOUS DOUBTS

On 3 February 2014, 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. Commission's doubts concern the compliance with Articles 8(4) and 13(2) of the Access Directive in conjunction with Article 8 of the Framework Directive and Article 16(4) of the Framework Directive, in particular:

- incorrect implementation of benchmark with regard to FTRs in Latvia and
- creation of barriers to the internal market.

Concerns of the Commission

In accordance with the TR Recommendation, NRAs should have ensured that termination rates were implemented, amongst other things, at a symmetric cost efficient level as of 31 December 2012. In the context of wholesale call termination markets, and given in particular their characteristics and the associated competitive and distributional concerns, the cost efficient rate is normally the one resulting from a pure BU-LRIC methodology.

Article 19(2) of the Framework Directive provides NRAs the possibility not to follow a recommendation, but in such circumstances they have to provide reasons for such deviation. At the same time, any alternative regulatory approach chosen by the NRA other than the one recommended by the Commission has, according to the Article 19 of the Framework Directive, to comply with the other provisions of this Directive and, in particular, with Articles 8(4) and 13(2) of the Access Directive in conjunction with Article 8 and 16(4) of the Framework Directive.

On the one hand, the Commission recognises that the application of a two-part tariff, consisting of a fixed fee (call set-up) and a variable part (per minute fee) is not uncommon in relation to fixed call termination services.

On the other hand, the Commission points outs that, even though SPRK proposes a significant decrease of the fixed termination rates when compared with the current levels, by setting an additional fee (call set-up fee) over and above the average per minute fee derived by means of benchmarking, the total FTRs proposed by SPRK are not set on the basis of an efficient operator and therefore do not serve to promote efficiency and sustainable competition and maximise consumer benefits also taking into account prices available in comparative competitive markets.

Namely, SPRK sets the variable (per minute) part of FTRs on the basis of benchmark against an arithmetic average of 6 Member states[4] which applied the pure BU-LRIC methodology by September 2013, in the amount of EUR 0.000785 per call minute. Additionally, SPRK allows operators to charge a call set-up fee of EUR 0.000845 per call. Furthermore, according to the Commission, assuming a 3 minute call[5], the total FTRs would clearly exceed the rates set by countries which have already implemented a pure BU-LRIC cost model.

The Commission expresses the view that the total costs of call termination in fixed networks in Latvia should correspond to the pure BU-LRIC costs in the benchmarked Member States, and not only a part of them. As a consequence of the fact that total costs of fixed call termination exceed the average by a large margin, the Commission concludes that SPRK substantially departs from the pure BU-LRIC methodology without providing a sufficient economic justification.

BEREC's Assessment

BEREC assesses the serious doubts related to the incorrect implementation of benchmarking in three parts: the first part deals with the methodological issues of the benchmark undertaken by SPRK and the second with the application of the criteria specified by SPRK. Then, BEREC assesses whether the SPRK benchmark creates barriers to the internal market.

1. **Methodological issues**

BEREC fully supports the Commission's doubts concerning the benchmarking methodology used by SPRK: benchmarking rates for a given service should be performed taking into account all the components of that service, and not only part of them. In the particular methodology proposed by SPRK, a significant component of the Latvian FTRs has been disregarded, with the effect that total FTRs lead to a value which exceeds (the average of) the benchmarked termination rates, by adding the call set up fee on top of a per minute fee.

[4] France, Italy, Malta, Slovakia, Ireland and The Netherlands
[5] As used by BEREC in their comparative reports

Namely, the total FTR set by SPRK[6] exceeds the arithmetic average of the six benchmarked Member States[7], merely because benchmarked values are inclusive of call set-up (where they exist), while Latvian ones aren't.

BEREC supports the Commission's view that the application of a two part tariff, consisting of a fixed fee (call set-up) and variable part (per minute fee) is not uncommon in relation to the fixed termination services. However, use of either one part or two part tariff structure should lead to the same total tariff (or cost) for a given service, regardless of which method is adopted. In other words, there should be no risk of arbitrage resulting from the existence of two part tariff structures, as long as the same total cost is recognised and recovered, as with one part tariff structure. Therefore, it is hardly possible to objectively justify different average cost/price levels, by means of tariff structures.

BEREC is therefore of the view that SPRK should ensure that the total costs of call termination in the fixed networks in Latvia, consisting of a fixed part (call set-up) and variable (per minute) part, as is currently the price structure, correspond to the averaged pure BU-LRIC costs.

In this respect, BEREC supports the Commission's view that SPRK departs substantially from the pure BU-LRIC methodology without providing a sufficient economic justification that the alternative methodology would equally achieve the policy objectives and regulatory principles set out in Article 8 of the Framework Directive, and would take account of prices available in comparable competitive markets in line with Article 13(2) of the Access Directive.

2. Application of benchmarking criteria

BEREC notes that the outcome of any termination rates international benchmarking and the corresponding assessment vis-à-vis its' compliance with Recommendation no. 12 of the TR Recommendation[8], depend to a significant extent on the sample included in the benchmark.

With reference to the benchmark in question, SPRK stated that it had analysed all the European Union countries and only had taken into account those countries which – at the time of the benchmark (July – September 2013) had already notified to the Commission and had adopted FTR measures based on pure BU-LRIC methodology.

The following country cases have been taken into account by SPRK in its benchmark:

- France (FR/2011/1236)
- Malta (MT/2012/1402)
- Ireland (IE/2012/1371)
- The Netherlands (NL/2012/1284)
- Italy (IT/2013/1415)
- Slovakia (SK/2013/1455)

[6] Assuming the same 3 minute call duration, as indicated by the Commission and by the BEREC reports.

[7] The Commission has confirmed that rates in countries used by SPRK's benchmark represent total costs of fixed termination, i.e. include set-up fees to the extent they exist.

[8] „(...) *Any such outcome resulting from alternative methodologies should not exceed the average of the termination rates set by NRAs implementing the recommended cost methodology.*"

Considering SPRK's criteria, BEREC notes not all Member States that derived pure BU-LRIC FTRs have been included in the benchmark, for example Bulgarian FTRs (case BG/2013/1410) have not been included[9].

In BEREC's opinion, using the same criteria as those specified by SPRK and taking due account of the date when the benchmark had been carried out (from July until September 2013), it appears no reason not to include Bulgaria (BG/2013/1410) in the benchmark.

BEREC investigated this case (BG/2013/1410) and on a previously notified case (BG/2012/1316-1317-1318), CRC has proposed a glide-path based on international benchmarking from 1 July 2012 until 30 June 2013, date from which a pure BU-LRIC model would be used. The Commission noted this in its comments letter, stating that *"CRC sets FTRs in Bulgaria on the basis of a pure BU-LRIC model"*[10].

Apart from the Commission's comments letter other sources confirm that CRC was applying pure BU-LRIC FTRs as of 1 July 2013: the BEREC FTR Report as of January 2013[11], public information on the CRC website[12] or some of the previous BEREC´s phase II opinions[13].

BEREC therefore suggests that SPRK should consider including in its benchmark FTRs derived in all pure BU-LRIC countries at the time of the analysis.

3. Creation of barriers to the internal market

Concerns of the Commission

In its serious doubts letter, the Commission considers that due to the methodological flaw of the benchmarking, the proposed FTRs will remain for undetermined period of time significantly higher in Latvia than the average FTRs set in those Member States which set the rates on the basis of pure BU-LRIC model. The Commission notes that any such considerable differences in FTRs within the EU not only distorts and restricts competition but have a significant detrimental effect on the development of the internal market, i.e. it creates a considerable barrier to the single market, and, therefore, result in a violation of the principles and objectives of Article 8(2) and (3) of the Framework Directive. A harmonised approach in setting (fixed) termination rates is particularly important to ensure that regulators do not favour their national operators at the expense of operators in other Member States by not introducing fully cost-oriented termination rates.

Views of SPRK

SPRK takes the view that the whole Latvian telecom market amounts to around 0.1 % of the EU equivalent and that the fixed termination market contributes with less than 1 % of the

[9] SPRK clarified it has not included Austria and Denmark because of different tariff structure (peak/off peak) and lack of information to derive average rates.
[10] Comments letter of the Commission in case no. BG/2013/1410, page 5
[11] BoR 13 (57)
[12] http://www.crc.bg/files/_bg/2225_BULRIC_FTR.pdf clearly indicates the figure 0,05 BGN represents avoidable costs (page 84 and next)
[13] BoR (13) 40 pages 16-17, BoR (13) 55 page 4

national telecom market. SPRK is thus of the view that the disputed draft measure will have close to no or no impact on the internal market.

BEREC´s assessment

Based on all available evidence gathered during the investigation phase, the view of BEREC is that the draft measure, if finally adopted, would in principle create barriers to the internal market and in this sense considers the serious doubts of the Commission to be justified.

BEREC has so far established quite a long history[14] of consistent assessment of the potential of termination rates set (without an adequate justification) by alternative methodologies than the one recommended by the Commission[15], to create barriers to the internal market. In general, considering the existence of the TR Recommendation towards a common regulatory treatment on call termination throughout Europe, BEREC has recognised draft measures in call termination markets do not lay obstacles to the internal market when two conditions are met, namely non-discriminatory application of regulated rates to both national and cross-border traffic and compliance with the recommended pure BU-LRIC costing methodology. In the current case, BEREC notes that the latter condition has not been met.

On the other hand, BEREC has also questioned on a number of occasions [16] the real material impact of the proposed price control measures on the internal market and this argument seems to be valid also in this case, taking into account both the magnitude of the cumulated impact of the methodological flaw and of the incomplete sample in the SPRK's benchmark and the size of the Latvian fixed termination market compared to the whole EU telecoms market.

While it is clear the methodological flaw and the incomplete sample in SPRK's benchmark present divergent impacts, the relative difference between the benchmarking value (corrected for the inclusion of Bulgarian pure BU-LRIC FTRs) and the total termination rates proposed by the SPRK (i.e. including call set-up), would reach approximately 6 %, when a 3 minute call is considered. On the other hand, although it is not the variation in termination rates *per se* that creates barriers to the internal market, but rather the unjustified national variation from a common methodology, the particular circumstances of this case have to be duly considered. Unlike previous cases, where cost models have been developed, the SPRK in the present case uses international benchmarking as a proxy to remedy the absence of a pure BU-LRIC cost model. Considering international benchmarks are by definition prone to some degree of approximation, a very limited margin of discretion should not be subjected to the same standard of proof as the one applied in the presence of cost models.

In addition, considering the relative difference between the proposed notified rates and the benchmarking value (corrected for the inclusion of Bulgarian FTRs), such a difference expressed in absolute terms would be hardly perceivable by the final users (if passed to retail prices). Indeed, it is hard to imagine how such a surcharge per service (one call) equal to price beginning with the first positive number on the fourth decimal place would considerably impact consumers´ preferences and behaviour, flow of services within the EU and the internal market as such. In this regard, BEREC considers the real barriers to the internal

[14] See BoR (12) 23, BoR (12) 61, BoR (13) 40, BoR (13) 47, BoR (13) 55, BoR (13) 94 or BoR (14) 07
[15] i.e. pure BU-LRIC cost model, or benchmarking
[16] See BoR (12) 61, BoR (13) 40

market possibly created by the proposed measure of the SPRK to be rather minor[17] and by no means considerable or significant as claimed the Commission.

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5. CONCLUSIONS

On the basis of the economic analysis set out in section 3 above, BEREC considers that the Commission's serious doubts regarding the draft decision of the Latvian Regulatory Authority on the modification of remedies on the markets for call termination on individual public telephone networks provided at a fixed location in Latvia, as expressed in the Commission's letter to SPRK of 3 February 2014, are justified in that the flaw in SPRK's proposed benchmarking methodology to set FTRs departs from the TR Recommendation without valid justification. In addition, BEREC notes that not considering all of the countries with a pure BU-LRIC FTR has a non-trivial impact on the result of the SPRK's benchmarking exercise, which artificially inflates the perceived difference between Latvian rates and average pure BU-LRIC FTRs across the EU.

On the other hand, BEREC takes the view SPRK's proposal could in principle create some barriers to the internal market, but that as such they are likely to be of reduced magnitude.

BEREC recommends that SPRK addresses the methodological flaw and consider revising the benchmark to the earliest convenience possible, so that FTR levels in Latvia are set in accordance with the TR Recommendation as soon as possible.

[17] It is worth mentioning that in case of Italian FTRs (BoR (13) 40) BEREC considered that any potential barrier to the internal market created by AGCOM´s proposals would be limited to 2013 with the proposed FTR twice higher than the average pure BU-LRIC tariffs from other countries and not to 2014, even though rates proposed for 2014 were higher than rates in other countries with implemented pure BU-LRIC rates (with the exception of Bulgaria) and even higher than the current average per minute rate proposed by the SPRK (0.00107 EUR based on a three minute call). BEREC also found the proposed Italian FTR for 2014 (0.00127 EUR) roughly in line with the average and did not come to the conclusion it would create any barrier to the internal market (even though it was not the final pure BU-LRIC model rate which was proposed only for 2015).