Body of European Regulators for Electronic Communications

BoR (17) 251

BEREC Opinion on

Phase II investigation

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

Case SK/2017/2010

Market for wholesale voice call termination on individual mobile networks (market 2) in Slovakia (remedies)

5 December 2017

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1. EXECUTIVE SUMMARY

On 25 September 2017, the European Commission registered a notification by the Slovakian National Regulatory Authority, RÚ[1], concerning termination rates in the market for wholesale call termination on individual mobile networks, being the fourth market review by RÚ. The notified draft measure concerns the proposal to set the maximum price for voice call termination on individual mobile networks of Slovak Telekom, Orange Slovakia, O2 Slovakia and SWAN Mobile from January 2018.

On 24 October 2017, 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, in particular, the fact that RÚ failed to justify why SWAN Mobile has a higher unit cost than other operators, as SWAN Mobile has until now voluntarily accepted symmetric MTRs.

In addition, the Commission is of the view that RÚ's allowance for a mark-up in its calculation of the WACC, to compensate Slovakian operators for their relatively smaller size and higher risk compared to European operators, is not commonly applied by other NRAs in the EU and does not constitute a "common regulatory practice".

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

2. INTRODUCTION

On 25 September 2017, the Commission registered a notification by the Slovakian National Regulatory Authority, RÚ, concerning termination rates in the market for wholesale call termination on individual mobile networks, being the fourth market review by RÚ. On 4 October 2017, a request for information (RFI)[2] was sent to RÚ and a response was received on 9 October 2017. On 10 October 2017, a supplementary RFI was sent to RÚ, and a response was received on 11 October 2017.

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 24 October 2017. 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 2 November 2017, the EWG sent a set of questions to the Slovakian National Regulatory Authority, RÚ. Answers were received from RÚ on 6 November 2017.

[1] Úrad pre reguláciu elektronických komunikácií a poštových služieb.
[2] In accordance with Article 5(2) of the Framework Directive.

Subsequently, the EWG met on 7 November 2017 in Dublin, Ireland. During this meeting the EWG held a discussion[3] with RÚ to gather further information and clarification in response to the questions submitted and to additional questions arising during the audition. The objective of the EWG was to reach clear conclusions on whether or not the Commission's serious doubts are justified.

On 14 November 2017, the EWG held a conference call with the Commission to discuss the case subsequent to the EWG's own meeting and audition with RÚ. On this occasion the Commission explained in detail to the EWG the reasons behind its serious doubts, which provided the EWG a more complete understanding of the case.

A draft opinion was finalized on 4 December 2017 and a final opinion was presented and adopted by a majority of the BEREC Board of Regulators on 5 December 2017. This opinion is now issued by BEREC in accordance with Article 7a(3) of the Framework Directive.

3. BACKGROUND

Previous notifications

The fourth market review was notified in November 2016 under case SK/2016/1955. RÚ defined four relevant mobile termination markets within the national territory of Slovakia corresponding to the networks of the four existing MNOs (Slovak Telekom, Orange Slovakia, O2 Slovakia and SWAN Mobile) and designated them as having SMP. RÚ imposed the following obligations on all of the SMP operators:

i. Access to specific network facilities,
ii. Transparency,
iii. Non-discrimination, and
iv. Price control based on a pure BU-LRIC cost methodology.

RÚ specified that the mobile termination rates would be set in a separate procedure[4] and that the termination of calls originated outside the EU/EEA was excluded from the price control obligation. At that time, the European Commission issued a no comments letter[5].

Current notification and the European Commission's serious doubts

Summary of current notification

The notified draft measure concerns the proposal to set the maximum price for voice call termination on individual mobile networks (MTRs) of Slovak Telekom, Orange Slovakia, O2 Slovakia and SWAN Mobile from January 2018. RÚ proposes that Slovak Telekom, Orange Slovakia, and O2 Slovakia apply a maximum price of 0.00825 EUR per minute, valid until a new price decision will be issued, while SWAN Mobile can apply an asymmetric maximum

[3] By teleconference call.
[4] The current MTRs, notified under case SK/2013/1462 (decision C(2013) 3830), result from the pure BU-LRIC methodology and amount to 1.226 EUR/cent per min.
[5] C (2016) 8842.

price of 0.00908 EUR per minute until 30 September 2019[6]. The tariffs of 0.00825 EUR per minute to be applied by Slovak Telekom, Orange Slovakia, and O2 Slovakia have been calculated through the BU-LRIC model.

RÚ offers its justification for setting asymmetric MTRs for SWAN Mobile on the basis of recital 17 and point 10 of the Termination Rates Recommendation by arguing that SWAN Mobile is a 'new mobile entrant' as it entered the market in 2015 and, therefore, it has not been active in the mobile market for more than 4 years.

RÚ is claiming that SWAN Mobile has a low market share, high entry costs for the creation of a customer base, and limited allocated frequency spectrum ranging only in the 1800MHz band[7] when compared to the other three MNOs[8]. RÚ concludes that due to existing strategic and economic barriers in the market for mobile voice termination[9], SWAN Mobile incurs 'higher individual unit costs' than the other three MNOs when terminating a call.

The maximum MTR to be applied by SWAN Mobile has been determined on the basis of data published by the Body of European Regulators for Electronic Communications (BEREC) from January 2016 (Termination rates at European level, January 2016)[10]. In particular, RÚ has calculated the maximum asymmetric price for SWAN Mobile as the arithmetic average of the applicable termination rates in the countries applying the pure BU-LRIC methodology[11], the value of which is 0.00908 EUR per minute. The difference between SWAN Mobile's MTR (resulting from the EU BU-LRIC average MTR) and the MTRs set for the other three mobile operators (BU-LRIC price resulting from the model) is 0.00083 EUR per minute; i.e. the MTR proposed for SWAN would be approximately 10% higher than that proposed for the other three mobile operators.

RÚ claims that it took into account the need to remove barriers to entry for the new entrant, while the asymmetric MTRs do not exceed the termination rates for the average European efficient operator. RÚ states that the conditions for the implementation of asymmetry in favour of SWAN Mobile will be regularly monitored by Slovakian NRA, and that the amount of asymmetry granted will be reassessed on the basis of the current developments and trends in the relevant market.

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[6] In the response to the RFI, RÚ explained that SWAN Mobile is currently applying the symmetric tariff of 1.226 EUR/cent per min on the basis of an agreement signed between all MNOs.

[7] In the response to RFI, RÚ clarified that they "took into account that before 2013 it was not possible to allocate frequencies under the market mechanism (electronic auction) and they were allocated following a selection process whose integral part was also a condition of even allocation of frequency spectrum. Swan entered the market when there were already 3 operators present, who used a part of it, which according to conditions of allocation of frequency spectrum was allocated evenly, this fact is discriminatory for Swan".

[8] RÚ specified that when SWAN Mobile entered the market in the second half of 2015, its share of the highly penetrated mobile communications market, based on the number of active SIM cards, was 3.23% as of 30 June 2016, with market shares of the other 3 MNOs each above 28%.

[9] RÚ mentioned the obstacles to the entry of another mobile operator into the market, namely: strategic barriers, e.g. limited frequency spectrum, the stable position of three established mobile operators on the market, inertia of customers when changing a mobile operator, high penetration of the SIM card market: 110.8% as of 30 June 2016, economic barriers, e.g. payments for assigned frequencies, investment demand, high initial cost of acquiring a customer base, technical and time barriers, e.g. dynamics of technological development, time - consuming establishment of a public mobile network; and the time it takes to get a significant number of customers.

[10] BoR (16) 90, available at http://berec.europa.eu/eng/document_register/subject_matter/berec/reports/6086-termination-rates-at-european-level-january-2016

[11] The following countries were included in the calculation: Austria, Belgium, Bulgaria, Czech Republic, Denmark, Greece, Spain, France, Croatia, Hungary, Italy, Luxembourg, Malta, Norway, Poland, Portugal, Romania, Sweden, Slovenia, Slovakia, United Kingdom.

According to RÚ, SWAN Mobile's actual costs of terminating a call are equal to the pure BU-LRIC termination fee as set out in the draft price decision for the other three MNOs plus additional costs associated with the use of the national roaming service. RÚ explained that at the time of calculating the termination rate on the mobile network, SWAN Mobile did not have a sufficient number of customers (according to RÚ, the figure was approximately 98,000) and its network only had partial coverage of the Slovakian population. RÚ also clarified that the holder of an individual authorization to use frequencies in the 1800 MHz frequency band, such as SWAN Mobile, is required to ensure coverage through its own network of 25% of the population of the Slovak Republic no later than 31 December 2015 and 50% of the population of the Slovak Republic no later than 31 December 2018. To ensure provision of services nationwide, SWAN Mobile currently uses a national roaming service provided by the host network Orange, which represents additional costs for SWAN Mobile.

The BU-LRIC model assumes a network of a hypothetical efficient operator, entering the market today.

RÚ has estimated the costs per asset category (RAN network elements, backbone network and transmission network elements), indirect network costs, wholesale billing, and working capital mark-ups. Based on data provided by operators, average mark-up values were calculated, which were then applied to the cost of facilities modelled according to the 'bottom-up' methodology. RÚ claims that these costs were included in the termination price only if the additional capacity required was due to the provision of termination services which requires the construction of new facilities (modelled according to the 'bottom-up' method) that form the basis for the calculation of additional costs.

With regard to the costs of spectrum, RÚ states that the model does not take into account the costs of acquiring spectrum, as it is not possible to determine which spectral load is linked to the additional capacity required to provide a termination service. However, while different frequency assignments do not appear as spectral costs, RÚ finds that network costs differ due to the higher or lower number of required base stations[12].

RÚ took into account this fact in the different termination rates proposed for the fourth operator, SWAN Mobile, whose radio spectrum is significantly different from the spectrum assigned to the other three SMP operators. Furthermore, RÚ claims that the objective physical unavailability of frequency bands for SWAN Mobile has meant that the operator would not be able to provide competing services without acquiring national roaming services[13].

With the notified measure, RÚ also assesses the Weighted Average Cost of Capital (WACC) and proposes to set it at the level of 5.76%, but adjusts the gearing for a hypothetical efficient operator.

RÚ calculates the cost of equity based on the Capital Asset Pricing Model (CAPM) using the following formula:

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[12] Based on the allocated frequency spectrum, RÚ considers in its response to the RFI that the average mobile operator uses frequencies in the 900/1800 MHz band for GSM technology, 1900/2100 MHz for UMTS and 800/1800/2600 MHz for LTE. RÚ calculated the values as the average of the operators' input data presented to RÚ during the collection of input data.

[13] In its response to the RFI, RÚ states that these were not taken into account in the model for the following reasons: the assumption that the hypothetical efficient operator would not be the customer of national roaming and uncertainties as to the costs of national roaming at the time of calculating the termination price.

$$R_e = R_f + \beta * (R_m - R_f) + SP$$

Where R_e stands for the cost of equity, R_f is the risk-free rate, β is the equity beta and R_m is the average return on the market portfolio. 'SP' is a 'business size surcharge' or 'size premium' published annually.

According to RÚ, this mark-up would reflect the risk of the variability in the return of the operators' shares in the long run perspective depending on the size of the undertakings, and which is derived from the market capitalization of the companies listed in the US stock exchange. It is unclear from the notification and from the responses to the RFIs how RÚ derived the mark-up on the WACC and its justification. Regarding the equity beta, it is unclear from the notification which beta value RÚ used and if it adjusted the estimated beta towards 1.

Summary of serious doubts

Mobile termination rates to be applied by SWAN Mobile

The Commission considers that the asymmetric rates proposed by RÚ do not comply with the relevant provision of the regulatory framework, for the following reasons:

1) *Compliance with Article 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 has serious doubts that higher MTRs for SWAN Mobile, which result in a price asymmetry with the pure BU-LRIC based MTRs of the other three MNOs, are in compliance with the Regulatory Framework.

The European Commission cannot identify any higher per unit incremental termination costs incurred by Swan Mobile than those incurred by the SMP operators, whose cost efficient rate has been set at the pure BU-LRIC rate of 0.00825 EUR per minute.

Such asymmetric MTRs for SWAN Mobile would result in higher MTRs for other existing operators and new entrant operators, which in turn will lead to higher retail prices and an associated loss in consumer benefit.

2) *Compliance with the non-discrimination principle as set out in the Article 8(5) (b) of the Framework Directive.*

The European Commission takes the view that the asymmetric termination rate proposed by RÚ would lead to a price discrimination of the other three MNOs vis-à-vis SWAN Mobile, and RÚ did not provide an adequate justification with respect to the objective cost differences that would warrant an asymmetric termination rate in favour of SWAN Mobile.

3) *Creation of barriers to the internal market.*

The European Commission considers that the RÚ decision would likely lead to the creation of a barrier to the internal market, as SWAN Mobile would be able to charge higher wholesale terminating rates than the other three MNOs for calls originated in other Member States, to the detriment of operators and their subscribers, who would suffer from higher rates in Slovakia. In addition, the European Commission points out that in most Member States a symmetric price control remedy was imposed on new entrants following their entry in the market. Different regulatory approaches adopted by the NRAs within the European Union would undermine the development of a consistent approach with respect to termination rates in the internal market.

Mark-up for company size in the WACC calculation

The European Commission considers that application of a mark-up ('Size premium') in the WACC calculation, which would reflect the risk of the variability in the return of the operators' shares in the long run perspective depending on the size of the undertakings, is not in compliance with Article 8(2)a and 8(5)d of the Framework Directive for the reasons below.

The European Commission does not consider the justification for the size premium provided by RÚ to be sufficient. The Commission considers that the traditional parameters of the WACC formula should be able to fully account for the non-diversifiable risk of the firms. Furthermore, it is not clear from the notified draft measure whether RÚ has in fact made an adjustment to the equity beta (rounding it up from [redacted] to 1) which adds considerable doubts over the appropriateness of the WACC parameters used.

The WACC value proposed by RÚ, being a subject of an unjustified size premium, does not promote efficient investment, innovation and competition in the relevant market and consumers may not have the maximum benefit in terms of choice, price and quality.

4. ASSESSMENT OF THE SERIOUS DOUBTS

On 24 October 2017, the European 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 European Commission's serious doubts concern the compatibility with EU law of RÚ's draft measure in its current form, in particular with the requirements referred to in Articles 8(4) and 13(2) of the Access Directive in conjunction with Articles 8 and 16(4) of the Framework Directive. Furthermore, the Commission considers, at this stage, that the draft measure may create barriers to the internal market.

The Commission considers that the notified draft measure falls under the Commission's powers of ensuring the consistent application of remedies as set out in Article 7a of the Framework Directive, as the notified measures aim at imposing an obligation on an operator in conjunction with Articles 9 to 13 of the Access Directive.

The following sections of this BEREC Opinion analyse the Commission's serious doubts by describing BEREC's assessment of the serious doubts relating to the mobile termination rates to be applied by SWAN Mobile, covering issues around the maximisation of consumer benefits, the non-discrimination principle, and the creation of barriers to the internal market. Additionally, there is an assessment of the serious doubt relating to the mark-up for company size in the WACC calculations, covering issues around the promotion of efficiency, the sustainability of competition, and the maximisation of consumer benefits in terms of choice, price, and quality.

Mobile termination rates to be applied by SWAN Mobile

Concerns of the Commission

With respect to this serious doubt, the concerns of the Commission centre on a lack of compliance with Article 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, in its letter C (2017) 7251 Final expresses serious doubts regarding price control remedies for the markets for mobile call termination in Slovakia for the following reasons:

i. The Commission refers to Article 8(3) of the Framework Directive, envisaging NRAs contributing to the development of the internal market by cooperating with each other, as well as with the Commission and BEREC in a transparent manner to ensure not only the development of a consistent regulatory practice but also the consistent application of the Framework Directive and the Specific Directives (together, the Regulatory Framework). In addition, the Commission refers in this context to the Termination Rate Recommendation, setting out a consistent approach regarding price control obligations for fixed and mobile termination rates.
ii. The Commission takes the view that a cost orientation obligation based on a pure BU-LRIC methodology best promotes competition and consumer welfare as well as contributes to a level playing field among operators, eliminating competitive distortions in wholesale call termination markets.
iii. According to the Commission, RÚ has not provided sufficient explanations on the alleged significance in cost differences between SWAN Mobile and the other MNOs due to the spectrum assignments. Moreover, the Commission claims that RÚ fails to establish the direct relationship between higher termination rates for SWAN Mobile and SWAN Mobile's higher per unit incremental costs than the modelled operator. The Commission considers that, similarly to the case FR/2012/1304[14], the new entrant can benefit from the same economies of scale and/or scope as the host MNO and hence achieve the same unit costs irrespective of their actual market shares.

Views of RÚ

According to RÚ, the competitive situation in the Slovakian mobile market justifies allowing SWAN Mobile an asymmetric MTR in line with the EC Regulatory Framework. RÚ first emphasizes that SWAN Mobile is a new entrant that faces impediments on the retail market. RÚ referred to different impediments such as the highly penetrated mobile market and the fact that SWAN Mobile has low market shares. In addition, RÚ points out that SWAN Mobile holds a lower range of frequency spectrum than the incumbent operators which as a result incurs 'higher individual unit cost' for SWAN Mobile. Finally, RÚ argues that SWAN Mobile relies on a national roaming agreement that increases its per-unit costs.

BEREC's assessment

BEREC acknowledges that the Termination Rate Recommendation indicates that asymmetric termination rates can be justified under specific conditions. If it can be demonstrated that a new mobile entrant, operating below the minimum efficient scale, incurs higher per-unit

[14] European Commission, Decision to lift reservations pursuant to Article 7a of Directive 2002/21/EC as amended by Directive 2009/140/EC , https://circabc.europa.eu/d/d/workspace/SpacesStore/001eb961-c5c4-49d9-bb04-74af823e4bc4/FR-2012-1304%20withdrawal%20letter-non-confidential-EN.pdf

incremental costs, the NRA can entitle the new entrant to recover these higher incremental costs during a transitory period if there are impediments on the retail market to market entry and expansion.

SWAN Mobile entered the mobile market in late 2015, thus becoming a new entrant in this market. As of 1 July 2017 SWAN Mobile had achieved a market share (by subscribers) of [redacted]%.

In its written reply to the Commission, RÚ claimed that there are impediments on the retail market. In the reply to the RFI from the Commission, RÚ's response was mainly about impediments on the wholesale market. During the conference call, which the BEREC EWG held with the RÚ on 7 November, the Slovakian NRA claimed that the retail market is competitive and benefits from ongoing price competition. Therefore, in BEREC's view RÚ fails to demonstrate impediments on the retail market.

Based on this information, BEREC has assessed whether SWAN Mobile incurs higher per unit incremental costs due to differences outside the control of operator, in particular due to uneven spectrum assignment and the cost of national roaming.

BEREC acknowledges that the airtime rate negotiated for incoming calls in a national roaming agreement can potentially increase the incremental cost of an operator if this rate is set above the regulated MTR. However, BEREC recalls that as stated previously by the EC in case FR/2012/1304 "any cost difference between a host MNO and operators purchasing national roaming would largely depend on the negotiated airtime rate. However, unless the wholesale market for access and call origination to mobile networks is not effectively competitive, termination rates under a national roaming agreement should not normally exceed those of the host MNO".

In the present case, RÚ did not calculate SWAN Mobile's costs. Instead, RÚ used a benchmark of EU Member States, which apply a BU-LRIC model, to set the asymmetric MTR. Furthermore, from the commercial details of the national roaming agreement offer between SWAN Mobile and Orange provided by RÚ to BEREC, BEREC notes [redacted]. Therefore, in line with the EC serious doubts letter, BEREC does not identify any higher per-unit incremental termination cost incurred by SWAN Mobile due to its national roaming agreement.

BEREC acknowledges that uneven spectrum assignments can have an impact on the incremental cost of provision of mobile termination services. In particular, the need to implement more base stations might incur higher cost, which might lead to higher incremental cost of termination.

SWAN Mobile holds spectrum only in the 1800MHz band whereas the three other MNOs hold spectrum in the 800MHz band. This somewhat unbalanced repartition of spectrum might affect the incremental cost of voice call termination on SWAN Mobile's network if, for example, SWAN Mobile would have to rely on relatively more base stations. However, RÚ did not provide concrete evidence of SWAN Mobile's higher cost due its spectrum assignment.

In BEREC's view, RÚ fails to demonstrate cost differences outside the control of SWAN Mobile that could justify a deviation from the efficient cost. BEREC cannot identify any higher per unit incremental termination costs incurred by SWAN Mobile than those incurred by the other three

SMP operators, whose cost efficient rate has been set at the pure BU-LRIC rate of 0.00825 EUR per minute.

Based on the preceding assessment, BEREC agrees with the Commission's serious doubts that higher MTRs for SWAN Mobile that result in a price asymmetry do not comply with the Regulatory Framework.

Assessment on the non-discrimination principle

Concerns of the Commission

The Commission takes the view that, since the cost differences that would warrant asymmetric MTRs for SWAN Mobile are not adequately justified, the termination rate proposed by RÚ would lead to price discrimination of the other three MNOs vis-à-vis SWAN Mobile because all operators provide the same termination service over the same mobile network; a situation which may infringe the non-discrimination principle as set out in Article 8(5) of the Framework Directive.

Views of RÚ

In its answer to the RFI RÚ states that the asymmetric MTR could not lead to discrimination, referring to the higher costs of a new entrant. By taking into account the need for the entrant to achieve economic scale, the asymmetric MTR will lead to effective competition on the mobile market.

Article 8(5) of the Framework Directive imposes on NRAs the obligation to apply non-discriminatory regulatory principles and regulations to ensure the equality of treatment of operators in similar circumstances.

BEREC's Assessment

BEREC is of the view that RÚ has not put forward sufficient justification as to why the circumstances of SWAN Mobile are sufficiently different so as to justify a different treatment as regards the termination rates it provides. In such circumstances, the draft measure would lead to discrimination with regard to other providers of mobile termination which buy this service from SWAN Mobile, as noted by the Commission.

Although BEREC shares the view of the Commission, it remarks that there is a minor flaw in the Commission's analysis when mentioning that all operators provide the same service over the same mobile network, which is not the case. It is evident that each operator provides termination services on its own network. For example, SWAN Mobile has its own, limited network. However, on uncovered territory, SWAN relies on national roaming.

Assessment on creation of barriers to the internal market

Concerns of the Commission

The Commission argues that the draft measure would allow SWAN Mobile to charge higher termination rates than the other three MNOs for calls originated in other Member States, to the detriment of operators and their subscribers that will suffer from higher rates in Slovakia.

Furthermore, the Commission notes that in most Member States a symmetric price control remedy was imposed on new entrants. Therefore, the proposed measure would very likely lead to the creation of a barrier to the internal market.

Views of RÚ

In its answer to the RFI, RÚ confirms that it did not analyse the effects of the draft measure on the internal market, but took into account the economic and technical barriers on the market and referred to the Recommendation on termination rates for justification.

BEREC's Assessment

BEREC has already addressed a similar line of argument advanced by the Commission in previous cases and agrees with the Commission that – like in other cases[15] – also in this Slovakian case the new entrant's higher rates will also be paid by operators and ultimately their subscribers in other Member States from which the call originates. BEREC agrees that such obstacles are valid irrespective of the precise level of the termination rate and considers any unjustified national deviation from a common methodology to set rates, put forward by the Termination Rate Recommendation, susceptible to create barriers to the internal market.

However, BEREC also notes the Commission does not quantify this effect and this effect seems relatively minor given the size of the asymmetry, the market share of SWAN Mobile and percentage of traffic that is international. Therefore, it seems doubtful whether the notified measure would create a barrier to the internal market. At least this seems less important than the noncompliance with the non-discrimination principle.

In the present case, RÚ has not adequately justified a different treatment as regards the termination rates of SWAN Mobile. BEREC therefore is of the opinion that the draft measures may create a barrier to the internal market, and therefore shares the Commission's serious doubts.

Mark-up for company size in the WACC calculations

In its serious doubts letter the Commission makes three main points in support of its view that the inclusion of a mark-up for company size when calculating the WACC is not compliant with Articles 8(2)a and 8(5)d of the Framework Directive. These are, in summary, that:

1. In contrast to RÚ's claims, use of such a mark-up is not a common practice;
2. The principle of including a size premium was not sufficiently justified by RU; and
3. The derivation of the value of the size premium used by RU was not sufficiently explained.

BEREC considers the Commission's concerns, the views of RÚ and presents its assessment of each of these points in turn below.

Whether a size premium is commonly applied by other NRAs in the EU

[15] Specifically, cases FR/2012/1304 and NL/2012/1284-1285.

Concerns of the Commission

In explaining this concern the Commission simply explains that, in contrast to what has been claimed by RÚ, the use of a size premium is not commonly applied by other NRAs in the EU and does not, in the Commission's view, constitute a 'common regulatory practice'. In informing this view the Commission's RFI had sought clarity on RÚ's view on this.

Views of RÚ

In response to the RFI, RÚ explained that it has included a size premium in the calculation of the WACC for all of its pricing decisions made since 2008, and noted that there is not currently a harmonised approach to WACC calculations at the EU level.

BEREC's Assessment

It is clear from RÚ's answers to the Commission that the inclusion of a size premium when calculating the WACC has been RÚ's established practice for many years, and we understand that this is the 21st market review to have been notified on this basis but the first in which serious doubts have been expressed on this issue.

However, we also note that detailed overviews of the current state of NRAs' practice in calculating WACCs can be found in both BEREC's annual 'Regulatory Accounting in Practice' reports[16] and the 2016 report produced by Brattle Group for the Commission.[17] Neither of these sources discusses the inclusion of a size premium when calculating the WACC using the CAPM to derive the cost of equity, as RÚ has done. Consequently, and although this does not constitute in itself a basis of a serious doubt by the Commission, BEREC agrees with the Commission that the use of a size premium is not commonly applied by other NRAs in the EU.

The lack of sufficient justification for the inclusion of a size premium in WACC calculations

Concerns of the Commission

The Commission explains its concern that the inclusion of a size premium has not been sufficiently justified by RÚ. It notes that the conventional calculation of WACC based on the CAPM, if suitably implemented, should appropriately capture the systematic (non-diversifiable) risk of Slovakian firms without any need for a size premium. It also explains that the systematic risk of Slovakian operators should already be captured through RÚ's use of Slovakian government bonds to determine the risk-free rate and by accounting for the Slovakian regulated firms' gearing. The Commission sought justification from RÚ in its RFI.

Views of RÚ

In its response to the RFI, RÚ explained that it had relied on the work of consultants in establishing the appropriate WACC methodology and calculating the value, and that it had been advised to include a size premium. The justification it offered was that the necessary

[16] BoR (17) 169, available at http://berec.europa.eu/eng/document_register/subject_matter/berec/reports/7316-berec-report-regulatory-accounting-in-practice-2017.

[17] EC, Review of approaches to estimate a reasonable rate of return for investments in telecoms networks in regulatory proceedings and options for EU harmonization, available at https://publications.europa.eu/en/publication-detail/-/publication/da1cbe44-4a4e-11e6-9c64-01aa75ed71a1/language-en.

input parameters for the WACC calculation had been calculated on the basis of the share prices of publicly traded companies that are larger than that for which RÚ needed to calculate the cost of capital, and that since larger companies are less risky than smaller ones it was necessary to include the size premium.

BEREC's Assessment

In considering the appropriateness, in principle, of including a size premium in the calculation of the cost of capital we note that consideration of company size is discussed in financial market theory. For example, BEREC's report on Regulatory Accounting in Practice 2017[18] notes it as an input to the Fama-French three-factor model[19]. However, it also points out that 'there has been a considerable debate on whether the risk premium associated with… company size… [is] statistically significant', and moreover notes that this is not an approach used by NRAs, which instead favour the CAPM.

On this basis we agree with the Commission that the conventional application of the CAPM should be able to appropriately capture the cost of capital of the regulated Slovakian company, and as a result agree with the Commission that the inclusion of a size premium is not sufficiently justified. We also note that even if we were to accept, in principle, the inclusion of a size premium RÚ has not presented any evidence to justify why it is necessary in Slovakia.

The derivation of the value of the size premium used by RÚ

Concerns of the Commission

The Commission explained simply that RÚ had not provided sufficient information on the value of the size premium that it had used, and sought justification from RÚ in its RFI.

Views of RÚ

In its response to the RFI, RÚ explained that the size premium was based on information published by Duff & Phelps, apparently relating to US companies.

BEREC's Assessment

We note that although RÚ alluded to the source of the size premium that it has used in its response to the RFI it did not pinpoint the value or explain why this value is appropriate for use in calculating the WACC of Slovakian companies. As a result, we agree with the Commission that the value of the size premium is not sufficiently justified by RÚ.

Although it appears to be a secondary point, the Commission also noted a lack of clarity as to whether the equity beta value was an adjusted figure, casting further doubt on RÚ's calculations. Based on further information provided to the EWG we have been able to corroborate that the equity beta value used by RÚ is indeed an 'Adjusted Beta' value sourced from Bloomberg and including a so-called Blume adjustment. As noted in the Brattle Group

[18] See BoR (17) 169, footnote 9.
[19] The Fama–French three-factor model is a model designed by Eugene Fama and Kenneth French to describe stock returns. The three factors are (1) market risk, (2) the outperformance of small versus big companies, and (3) the outperformance of high book/market versus small book/market companies.

report, it is unclear whether such an adjustment is appropriate in the case of telecommunications operators, and its use is not recommended.[20]

Finally we note that the ultimate result of RÚ's calculations is a pre-tax WACC of 5.76%. Despite the inclusion of the size premium as part of RU's calculation this value is low relative to the average pre-tax WACC values reported by BEREC in 2016 for mobile services.[21] The removal of the size premium would leave RÚ's WACC lower still, other things being equal.

On the basis of the analysis set out above, BEREC concludes that the Commission's serious doubts regarding the mark-up for company size in the WACC calculation are justified.

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 Slovakian National Regulatory Authority on termination rates in the market for wholesale call termination on individual mobile networks, as expressed in the EC's letter to RÚ of 24 October 2017 are justified.

BEREC is of the opinion that RÚ fails to demonstrate cost differences outside the control of SWAN Mobile that could justify a deviation from the efficient cost. BEREC cannot identify any higher per unit incremental termination costs incurred by SWAN Mobile than those incurred by the other three SMP operators. Therefore, BEREC agrees with the Commission's serious doubts that higher MTRs for SWAN Mobile that result in a price asymmetry do not comply with the Regulatory Framework.

Furthermore, BEREC is of the view that RÚ has not put forward sufficient justification as to why the circumstances of SWAN Mobile are sufficiently different to justify different treatment with respect to its termination rates. In such circumstances, the draft measure would lead to discrimination with regard to other providers of mobile termination which buy this service from SWAN Mobile, as noted by the Commission.

With respect to the creation of barriers to the internal market, BEREC is of the view that RÚ has not adequately justified different treatment regarding the termination rates of SWAN Mobile, and therefore shares the Commission's serious doubts.

Regarding the serious doubt concerning the WACC calculations, the EWG finds that:

i. There is no evidence to support the inclusion of a size premium when calculating the WACC using the CAPM to derive the cost of equity, as RÚ has done.
ii. The conventional application of the CAPM should be able to appropriately capture the cost of capital of the regulated Slovakian company.

[20] EC, Review of approaches to estimate a reasonable rate of return for investments in telecoms networks in regulatory proceedings and options for EU harmonization, Section VI.C.2.
[21] See BoR (16) 159, Section 6 on mobile values, and note that the 2017 version of the same report does not contain equivalent information. http://berec.europa.eu/eng/document_register/subject_matter/berec/reports/6479-berec-report-regulatory-accounting-in-practice-2016.

iii. Although RÚ alluded to the source of the size premium that it has used in its response to the RFI it did not pinpoint the value or explain why this value is appropriate for use in calculating the WACC of Slovakian companies.

Consequently, the EWG agrees with the Commission that the inclusion of a size premium is not sufficiently justified.

Therefore, to reiterate, BEREC considers that the Commission's serious doubts regarding the draft decision of the Slovakian National Regulatory Authority on termination rates in the market for wholesale call termination on individual mobile networks, as expressed in the EC's letter to RÚ of 24 October 2017 are justified.