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Freshly squeezed?

RE-REGULATING EUROPE'S BROADBAND NETWORKS

The European Commission has recommended major changes in the regulation of fixed broadband networks. Instead of national regulators setting prices for access to superfast broadband networks, access providers should have a lot more commercial freedom to set prices themselves. Regulators do, however, still have to safeguard competition in downstream markets by applying margin squeeze tests. In July 2014, Ofcom's response gave an early indication of how national regulators will meet this challenge.

Europe has set itself ambitious targets for the roll-out of new superfast broadband. By 2020, the aim is to give all households access to broadband speeds above 30 Mb/s (and 50% of households speeds of 100 Mb/s). On current trends, it is likely to fall far short of those. Investment, some operators have argued, has been inhibited by uncertainty over access price regulation. Last

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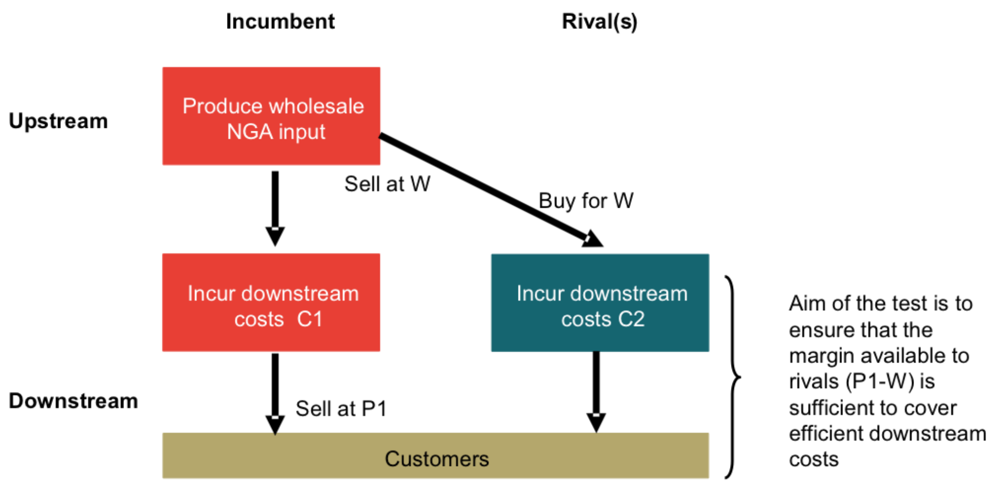
year, therefore, the European Commission (EC) recommended[1] a new approach to the regulation of dominant fixed network operators.

The key change that the EC wanted to see was for operators, not regulators, to set wholesale prices for access to superfast broadband. The intention was to make investment more attractive, and allow flexibility in the retail pricing of superfast products. Moreover, whilst regulators may feel qualified to model the wholesale costs of existing copper networks accurately, doing the same for the new superfast networks is much more of a challenge.

Greater pricing freedom does not, however, come without conditions. First, copper network access prices would continue to be controlled by the regulators, which will continue to constrain the retail prices of traditional broadband products. The EC expected that this would also act as some constraint on the retail prices that can be charged for superfast broadband.

Second, the EC wanted dominant operators to be required to offer downstream rivals access to both copper and superfast broadband networks without any non-price discrimination (e.g. unjustified delays in processing of downstream rivals' orders). The EC sought to address this risk by requiring that both the retail arm of the dominant operator and its downstream rivals are treated "equivalently".

Last, but definitely not least, the EC recommended that the pricing of superfast broadband products should be subject to an "ex ante" margin squeeze (MSQ) test. The basic principle of such a test is shown schematically below.



[1] Commission recommendation on consistent non-discrimination obligations and costing methodologies to remote competition and enhance the broadband investment environment - C(2013) 5761, September 2013.

Efficient downstream rivals, dependent on access to the network of an operator that is dominant in the upstream market, should have access on terms that would enable them to replicate profitably the dominant operators' superfast broadband retail offers.

The application of a MSQ test raises a number of questions about the mechanics of the test: what are the relevant downstream costs, to which products the test should apply, and whether the test should apply ex ante or ex post, amongst others. In July 2014, the United Kingdom's Office of Communications (Ofcom) became one of the first national telecoms regulators to indicate how it intends to do the job. We consider next some of the key questions that a MSQ test needs to answer and how Ofcom has proposed to address them.

TESTING QUESTIONS

Applying correct economic principles is important to getting the mechanics of MSQ tests right. But translating them into practice creates some challenges. Take the approach to retail costs. The Commission starts from the proposition (consistent with competition law) that the costs of the dominant operator's own downstream business should be the benchmark, as this would also reflect the costs of a rival of equal efficiency. However, the EC also recognises that national telecoms regulators may want to allow for a "reasonably efficient", but smaller, rival to have higher costs. If such adjustments are made, then the margin required of the dominant operator is likely to be higher.

These adjustments could be justified if there were economies of scale – in, for example, marketing or advertising or infrastructure. However, in the case of superfast broadband, downstream rivals are likely to be migrating existing copper-based broadband customers to fibre rather than acquiring new ones. This may reduce fixed advertising or marketing costs. Moreover, there may be less need for fixed investment to deliver most forms of superfast broadband, if "virtual unbundled" wholesale products are used, than is the case for copper-based "unbundling".

On the other hand, the pricing of wholesale products may involve fixed fees as well as volume-related charges, which would mean that downstream margins could increase with scale. Regulators will need to balance these issues when setting a MSQ test that considers smaller operators' ability to compete.

Ofcom proposes an "adjusted equally efficient operator" benchmark, whereby the downstream costs of the incumbent operator are adjusted to reflect disadvantages that (in Ofcom's view) a downstream rival may face. Two adjustments are proposed, although neither is directly related to scale: first, to reflect the (potentially higher) backhaul costs that BT's downstream rivals incur; and second, to base the test on their (lower) average customer lifetimes. Ofcom is also proposing that the margin should allow for a contribution to the recovery of fixed and common costs, by using a LRIC+ cost benchmark.

'FLAGSHIP' OR 'NICHE'

MSQ tests are typically applied either to particular products, reflecting complaints by affected parties, or to the combination of the dominant operator's retail products. However the EC has recommended that national regulators should focus on "flagship" and "niche" products.

The EC's concern is clear. If product-by-product investigations oblige dominant operators to maintain a specific margin on every new product launched, this may inhibit their ability to price flexibly at retail to reflect the exploitation of economies of scope. And if a dominant operator that wishes to accelerate fibre take-up is obliged to increase superfast broadband retail prices as a result of the application of a product-by-product test, this may increase inefficiencies and inhibit innovation. On the other hand, applying an MSQ test to the product portfolio as a whole may allow too much flexibility, if it enables a dominant operator to target market segments most prone to switching.

The key is to ensure that the MSQ test does not promote inefficient entry, or foreclose efficient entry. A more invasive test, at a disaggregated level, may over-encourage entry. But a less invasive, more aggregated, test may allow dominant operators to target specific downstream rivals and/or market segments where they face most competitive threats.

Furthermore, the Commission recognises that flagship broadband products are most likely to be bundled with telephony and pay-TV (triple-play bundles/3P) and with mobile (quadruple-play/4P). This raises further questions about the appropriate product scope to be used in MSQ tests. In some countries, the dominant operator may lack the economies of scope available to some of its rivals, for example through bundling superfast broadband with mobile, or offering premium content. Should this be taken into account – i.e. should regulators balance any disadvantage that a smaller rival may face from relatively higher (average) retail costs against any advantages that downstream rivals may enjoy through access to premium content or bundling with mobile?

Departing somewhat from the EC recommendation, Ofcom proposes to apply an aggregate test across BT's entire superfast broadband portfolio - to allow flexibility in the recovery of fixed and common costs across products, and avoid the difficulty of allocating fixed and common costs to each. It has also included the cost of BT's TV content in the relevant downstream costs. It wants them recovered across the whole of BT's broadband customer base, rather than in proportion to the take-up of BT TV by fibre-based and copper-based customers. This would likely lead to a higher proportion being allocated to fibre based broadband customers. Ofcom is not proposing to reflect explicitly in the margin test any potential advantages that BT's downstream rivals may enjoy from, for example, access to content.

BEFORE AND AFTER?

Telecoms regulators normally focus on network, or wholesale, costs, in order to set wholesale prices. Detailed methodologies and reporting requirements have been developed for this purpose. But applying "ex ante" MSQ tests requires them to assess retail costs, for which similar reporting requirements often do not exist.

Most MSQ investigations have in practice been undertaken "ex post". They run typically over many months, and in some cases years, as regulators and competition authorities need to extract and then assess information about the incumbent's retail costs. Rival operators are also likely to be ill-prepared to provide information about their retail costs. If the three-month timetables proposed by the EC to complete investigations are to be met, new reporting arrangements will be needed.

By setting out the assumptions it will use, Ofcom is seeking to provide BT with sufficient information to allow it to set prices which comply with the test applied "ex ante". But Ofcom is proposing to apply the test using actual figures for take up of BT's superfast broadband products, which BT must report on every six months, rather than rely on forecasts. This effectively means that Ofcom does not intend to pre-approve the products/pricing offers of BT. Whether Ofcom will be able to comply with the EC's recommendation that complaints should be dealt with "within four months" remains to be seen.

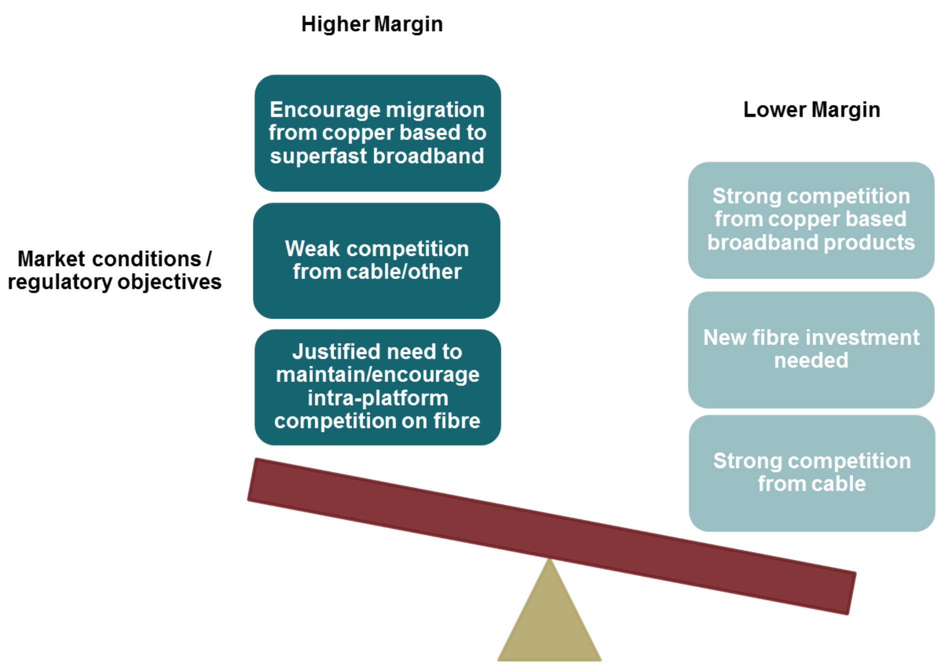
ONE SIZE DOESN'T FIT ALL

Whilst the application of a MSQ test raises a number of questions about the mechanics, MSQ tests are far from mechanical exercises. There are important policy choices to be made which guide how the mechanics should be applied.

The EC's aim is to strike a balance between promoting sustainable competition and providing incentives for investment in next generation access. An MSQ that allows downstream rivals to increase margins will shift more of the total return that can be earned from superfast broadband from wholesale to retail markets. This, in turn, can be expected to:

- Stimulate competition in the downstream fibre-based superfast broadband market;
- Encourage migration of broadband customers from legacy copper-based broadband products to fibre-based broadband; but also
- Make network investment by the incumbent (and potentially by alternative network operators) less attractive.

The right approach for national regulators will depend, at least in part, on the current state of competition. A regulator overseeing a retail market with a strong dominant operator may want to see a higher margin (to promote intra-platform competition) than a regulator overseeing a market with a very high degree of infrastructure competition (cable, wireless and/or other), and where copper-based broadband is considered to be a close substitute for fibre-based products. The chart below summarises the implications for margins of these factors.



In addition to the conditions of competition, to avoid double jeopardy – clearing the dominant operators' offers, only for them to be prosecuted and fined by the competition authority[2] – telecoms regulators may also be tempted to set relatively high margins. It will be interesting to see if approaches differ between those telecoms regulators that also administer competition law, and those that do not.

CHALLENGES AHEAD

The Commission's Recommendation reflected its concern over a divergence in approaches to the regulation of dominant operators taken by national regulators. But the key question is whether national regulators respond differently to similar situations, or whether differing situations justify different regulatory approaches. Ofcom appears to be pursuing a middle course, by proposing to adopt an "adjusted equally efficient operator" test, which would seek to maintain the current state of copper-based competition in fibre. This note shows how different market conditions could well lead other national regulators to have different aims, justifying different approaches.

2 In the EC ex post margin squeeze competition case against Telefonica, the national regulatory authority had 'cleared' the Telefonica offers that were then found by the EC to have led to a margin squeeze.

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