NGA wholesale pricing regulation: interpreting the EC's economic replicability tests

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The European Commission's (EC's) 2013 Recommendation stated that ex-ante price control of next-generation access (NGA) wholesale products should be replaced with an economic replicability test (ERT).[1] National regulatory authorities (NRAs) are implementing ERTs and have encountered several difficulties. This article reviews some of them and describes how Analysys Mason helped the NRAs to address these difficulties.

The EC has introduced the ERT to allow more pricing flexibility for NGA products

The stated aim of the 2013 Recommendation was to provide incumbent operators with greater incentives to invest in next-generation access (NGA) networks by allowing more pricing flexibility, which the EC recognised as being necessary to offset the uncertain demand for NGA networks. The EC, for example, mentioned testing price points and penetration pricing (low initial pricing so as to increase demand) and sharing investment risk between access seekers and SMP operators (for example, through differentiated wholesale access prices depending on the level of commitment from the access seekers). If certain conditions are met,[2] the NRAs are advised not to use cost-oriented price controls for NGA wholesale products and instead use the ERT to ensure that alternative operators can replicate the retail offers of the operator with significant market power (SMP).

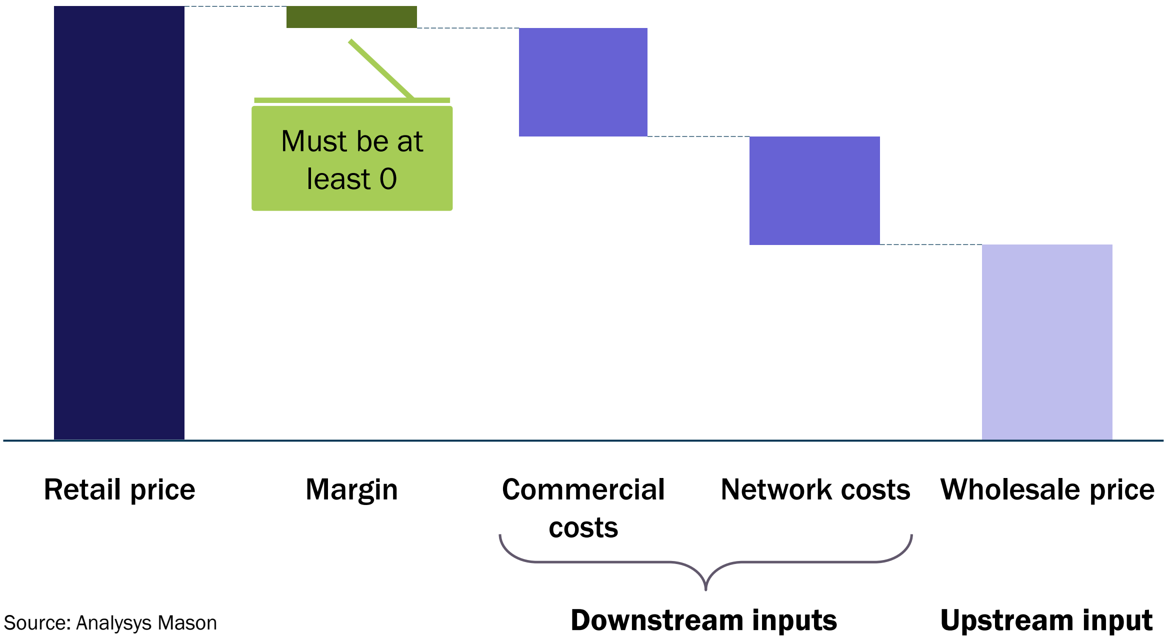
There are some important differences between the ERT and typical margin squeeze tests

The ERT is based on margin squeeze principles developed under (ex-post) competition law and ex-ante regulation (see Figure 1). In essence, it therefore tests whether there is sufficient economic space for a (hypothetical) retail operator to replicate the retail offers of a dominant operator based on wholesale (upstream) inputs sold from the same operator and takes into account the additional (downstream) network and commercial costs that are required.

1 For further details, see European Commission (Brussels, Belgium, 2013), *Commission recommendation on consistent non-discrimination obligations and costing methodologies to promote competition and enhance the broadband investment environment*. Available at http://ec.europa.eu/digital-agenda/en/news/commission-recommendation-consistent-non-discrimination-obligations-and-costing-methodologies.

2 Among others, that there is a price constraint from other infrastructure or from a regulated copper price and that Equivality of Inputs provisions are in place.

Figure 1: Schematic representation of a margin squeeze test



Source: Analysys Mason

The ERT deviates from typical margin squeeze test on some parameters, including the following.

- **The relevant retail products to be tested:** In the ERT (only) the most relevant retail products ('flagship products') are to be tested. This can be seen as an intermediate position between two extremes: testing at a market level (typical ex-post test) or all products individually (sometimes done ex-ante).
- **A 'reasonable' share of common costs should be included in the downstream costs:** Again, this is an intermediate position between an equi-proportional allocation of common costs (typical ex-post test) and no common costs (some offer-level ex-ante tests).
- **The test should be conducted with a discounted cash flow (DCF) approach** over a relevant time period set in accordance with the estimated average customer lifetime. Margin squeeze is typically done using a period-by-period[3] (PbP) approach and over a (longer) time period reflecting the investment period of access seekers (or a period of alleged abuse). The EC also specifies that downstream costs for shared assets (for example, core network or platforms) shall be included in the DCF test on an annualised basis (implying that the test should be done for an average subscriber or a cohort.)

It can be difficult to interpret and define specific parameters of the test

We have worked with several NRAs on the implementation of ERTs and have experienced the doubts and ambiguity related to the abovementioned deviations.

- The definition of a flagship product is not clear.
  - Is, for example, a triple-play bundle a '*product*' or is a product a specific triple-play combination at a particular speed and with a set of (video) content?

3 Essentially a profit and loss account over a given period in which capital investment costs are included through annualisation or depreciation.

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  - There is also a need to ensure both a limited administrative burden (which would seem to indicate a narrow definition) and that alternative operators can effectively compete across the product range (which would be a motivation for using a wider definition).

- How does one define the 'reasonable' share of common costs that are to be included? In our view, this needs to be considered consistently with the size of the tested increment or the choice of the flagship product. There are good economic reasons (based on price elasticity) for why it is not reasonable (or even desirable) to assume equi-proportional recovery of common costs from different retail products. On the contrary, it would appear normal (and consistent with the penetration pricing mentioned by the EC) to assume less than proportional recovery from new NGA products. However, this needs to be weighed against the risk for market foreclosure. In any case, there is no formula for estimating the reasonable share.
- The EC promotes the DCF test as being dynamic, but we believe that because of the short time period over which the test is to be conducted and because shared assets are to be annualised, the outcome of a DCF test will be very similar to that of a PbP test.

Time will be needed to reach consensus

NRAs are only now in the process of working through the initial implementations of ERT tests. It is clear that there are areas in which there will be very different interpretations. This may not be a bad thing because market structures and commercialisation strategies of SMP operators differ between countries. The EC and The Body of European Regulators for Electronic Communications (BEREC) are also likely to have a role in defining some of the key parameters in order to ensure regulatory certainty. However, these interpretations need to be consistent with regulatory objectives and with economic theory.

Analysys Mason has extensive experience of supporting NRAs, SMP operators and alternative operators on margin squeeze tests in both ex-post and ex-ante contexts. We have also supported multiple NRAs on their implementation of the ERT.

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