Commission for
Communications Regulation

Consultation Paper

# Consultation on retail minus wholesale price control for the WBA market

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All responses to this consultation should be clearly marked:- "Reference: Submission re ComReg 05/67" as indicated above, and sent by post, facsimile, e-mail or on-line at www.comreg.ie (current consultations), to arrive on or before 17h30 on 16 September 2005 to:

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Please note ComReg will publish all respondents submissions with the Response to this Consultation, subject to the provisions of ComReg's guidelines on the treatment of confidential information – ComReg 05/24

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# 1 Executive Summary

The Commission for Communications Regulation ('ComReg') is initiating this consultation as an amendment of obligations which were imposed on an interim basis following the market review of the wholesale broadband access (WBA) market in Ireland (the 'market'). As part of its analysis of the Market ComReg identified competition problems, in particular the possible leverage of market power by eircom Limited ('eircom') in the Market into the downstream prospectively competitive, retail market for broadband services, by way of a margin squeeze (also known as a price squeeze).

ComReg proposes to address the competition problems identified in the Market by applying a retail minus price control. The objective of this consultation is to propose an amendment to the existing interim price control framework.

ComReg's aim is to develop a methodology for calculating retail minus which will be transparent in its methodology and operation, and which will offer greater predictability to the market. ComReg notes that any margin set should neither distort incentives to invest in infrastructure, nor encourage inefficient market entry.

In this consultation, ComReg considers whether regulatory objectives would better be achieved by applying a retail minus control ex post or ex ante. Given the circumstances prevalent in the Market (as identified by ComReg in its analysis of the Market), ComReg is currently of the view that it would not yet be sufficient to rely on an ex post margin squeeze test in order for ComReg to achieve its objectives described in section 12 of the Communications Regulation Act 2002. In that regard, it is ComReg's view that if the Market were more mature and closer to effective competition, then an ex post test would be the appropriate way in which to test for a margin squeeze. An ex ante control would preclude potential margin squeeze, and would offer greater predictability for investment, and transparency in implementation and operation.

The key principles of the proposed control can be summarised as follows:

- the overall approach should be forward-looking, assessing economic costs and revenues over time, and building in judgements about the likely future value of variables

- eircom's costs and revenues should be used as the basis for establishing those of a similarly efficient operator, and these should be modified to take account of differences in scale, costs which would be borne by efficient new entrants but not by eircom, and of the evolution of prices

- a discounted cash flow (DCF) should be adopted, with a DCF analysis carried out over a 5 year period, and truncated with a terminal value

- the margin squeeze test should be applied on a product by product basis with a separate control for each wholesale and retail product pair

- the margin should be reviewed annually, unless circumstances in the market change significantly

- where eircom changes prices of existing products eircom will not be required to submit the proposed changes to ComReg prior to notifying the wholesale market.

- where eircom introduces new products it will be required to submit any proposals to ComReg in advance, and will be required to provide the information necessary to assess whether or not there is a potential margin squeeze.

- the wholesale market should be notified 15 working days in advance of any proposed change to wholesale prices.

ComReg welcomes comments on this consultation. The consultation period will run until 16 September 2005.

# 2 Introduction

## 2.1 Purpose of the consultation

ComReg is initiating this consultation to enable the public and interested parties to make submissions in respect of ComReg's proposals to amend, in accordance with Regulation 15 of the European Communities (Electronic Communications Networks and Services) (Access) Regulations 2003, certain of the obligations imposed on eircom in relation to the Market. In the course of the process leading up to the definition and analysis of the Market, ComReg consulted on a number of issues underpinning retail minus as a means of price control, and received preliminary comments from industry.

This consultation refers to wholesale bitstream products that are used as inputs by providers of retail broadband services to offer broadband internet access services to consumers and businesses. Currently, eircom is the main provider of wholesale broadband access products, and provides these products and services service both to its own retail arm and to competing operators.

The proposals for the implementation of an amended retail minus price control mechanism are designed to replace the existing interim price control and to ensure that potential competition problems identified in the analysis of the Market, conducted by ComReg, continue to be adequately addressed. In particular, ComReg is concerned about the possible leverage of market power by eircom in the Market into the downstream prospectively competitive retail market for providers of retail broadband services. The amended retail minus scheme is intended to ensure that the potential competition problems in the Market continue to be addressed and also to facilitate the emergence of effective competition in the retail market for broadband services and prevent anti-competitive practices without compromising desirable investments at a network level.

## 2.2 Regulatory objectives under the Communications Regulation Act, 2002

Section 12 of the Communications Regulation Act, 2002 outlines the objectives of ComReg in exercising its functions. In relation to the provision of electronic communications networks, electronic communications services and associated facilities these objectives are to:

- promote competition
- contribute to the development of the internal market, and
- promote the interests of users within the European Union.

It is ComReg's view that these proposals are in line with the objectives set out in the Communications Regulation Act, 2002. The purpose of the proposals is to seek to promote competition amongst operators to ensure that end-users derive the maximum benefit in terms of price, choice and quality.

## 2.3 Regulatory Framework

Four sets of Regulations,[1] which transpose into Irish law four European Community directives on electronic communications networks and services,[2] entered into force in Ireland on 25 July 2003. The final element of the European electronic communications regulatory package, the *Privacy and Electronic Communications Directive*, was transposed into Irish law on 6 November 2003.

The new communications regulatory framework requires that ComReg define relevant markets appropriate to national circumstances, in particular relevant geographic markets within its territory, in accordance with the market definition procedure outlined in the *Framework Regulations*[3].

In its Recommendation on relevant product and service markets, the European Commission identified the market for wholesale broadband access as being a market which could be susceptible to ex ante regulation. ComReg initiated a national consultation on this market on 5 March 2004 (ComReg Document 04/25). ComReg received and analysed responses from industry, and responded to the consultation with a proposed draft measure on 29 July 2004 (ComReg Document 04/83). In Decision Notice 03/05 (Document Number 05/11r) ComReg designated eircom with Significant Market Power (SMP) in the market for wholesale broadband access and imposed a price control obligation.

ComReg's conclusion from its analysis of the Market was that a retail minus price control was necessary in the Market for two main reasons, namely:

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[1] Namely, the European Communities (Electronic Communications Networks and Services) (Framework) Regulations 2003 (S.I. No. 307 of 2003), ("the Framework Regulations"); the European Communities (Electronic Communications Networks and Services) (Authorisation) Regulations, 2003 (S.I. No. 306 of 2003), ("the Authorisation Regulations"); the European Communities (Electronic Communications Networks and Services) (Access) Regulations 2003 (S.I. No. 305 of 2003), ("the Access Regulations"); the European Communities (European Communications) (Universal Service and Users' Rights) Regulations 2003 (S.I. No. 308 of 2003), ("the Universal Service Regulations").

[2] The new regulatory framework for electronic communications networks and services, comprising of Directive 2002/21/EC of the European Parliament and of the Council on a common regulatory framework for electronic communications networks and services, ("*the Framework Directive*"), OJ 2002 L 108/33, and four other Directives (collectively referred to as "the Specific Directives"), namely: Directive 2002/20/EC of the European Parliament and of the Council on the authorisation of electronic communications networks and services, ("*the Authorisation Directive*"), OJ 2002 L 108/21; Directive 2002/19/EC of the European Parliament and of the Council on access to, and interconnection of, electronic communications networks and services, ("*the Access Directive*"), OJ 2002 L 108/7; Directive 2002/22/EC of the European Parliament and of the Council on universal service and users' rights relating to electronic communications networks and services, ("*the Universal Service Directive*"), OJ 2002 L 108/51; and the Directive 2002/58/EC of the European Parliament and of the Council concerning the processing of personal data and the protection of privacy in the electronic communications sector, ("*the Privacy and Electronic Communications Directive*"), OJ 2002 L 201/37.

[3] Framework Regulation 26.

- firstly the application of a retail minus scheme would ensure that an operator identified as having SMP in the wholesale bitstream market could not leverage its significant market power in the Market into the prospectively competitive downstream retail market for providers of retail broadband services by applying *margin squeezes*.
- secondly, a suitably designed retail minus measure affords an opportunity for ComReg together with industry to establish an environment in which there would be greater transparency and more certainty.

ComReg has stated that a retail minus price control in the Market could be applied on either an ex ante or ex post basis. ComReg, in ComReg Document 05/11r[4] (following on from its definition of the Market and its designation of eircom as having SMP in the Market), imposed an interim ex ante retail minus price control on eircom. ComReg indicated that this would be an interim measure that would apply until a subsequent consultation on a replacement price control was completed and ComReg issued a new direction on the application of a retail minus control in the Market. In this paper ComReg elaborates on its thinking in relation to ex ante and ex post application of retail minus price control. As set out in section 3 ComReg is currently of the view that an ex ante retail minus price control is appropriate at this stage in the development of the Market in Ireland. ComReg notes that the same conclusion was reached in the UK in its review of the WBA market.[5]

ComReg noted in ComReg Document 04/83[6] that the implementation of retail minus was complex, and that a number of issues would need to be resolved and as a result imposed an interim price control. In this consultation, ComReg addresses these issues in further detail and at the conclusion of this consultation process ComReg will impose (following notification to the European Commission) a price control as envisaged in the WBA market review.

## 2.4 Structure of Consultation Document

The remainder of this consultation document is structured as follows:

- **Section 3** outlines ComReg's approach to retail minus.
- **Section 4** examines the treatment of costs, revenues and profitability.
- **Section 5** discusses the implementation of the control
- **Section 6** outlines the regulatory impact assessment

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[4] Document No 05/11r; published on 17/02/05 - **Market Analysis - Wholesale Broadband Access (Decision Notice - Designation of SMP and Related Remedies)**

[5] *Wholesale Broadband Access Market: Explanatory Statement and Notification*, Oftel, 16 December 2003.

[6] Document Number 04/83 - **Market Analysis: Wholesale Broadband Access (Response to Consultation Document 04/25 and Draft Decision)**

- **Section 7** provides details with regard to the submission of comments
- **Annex A** provides the legislative basis
- **Annex B** contains a list of the consultation questions

# 3 APPROACH

## 3.1 Scope of review

As part of the process of defining and analysing the Market and identifying appropriate remedies to impose on eircom, ComReg consulted on a range of broad principles applicable to retail minus.[7] This consultation invites comment on ComReg's current position with regard to the application of a retail minus measure that would encourage competition in the Market and optimise the incentives to all operators to invest. ComReg believes that the measure adopted must meet the criterion of transparency in its implementation, and should offer enhanced certainty for all operators.

This consultation exercise is intended to explain to interested parties ComReg's preferred methodology for the application of a retail minus scheme in the future. This section sets out ComReg's proposals for how a margin squeeze should be assessed. This will be dealt with in a draft Direction to be published having considered responses to this consultation.

## 3.2 Objective of retail minus: counteracting margin squeezes

The primary objective of the wholesale price control is to ensure that an operator holding SMP in the Market does not leverage market power into the closely related downstream market for the provision of retail broadband services by engaging in what is known as a margin squeeze, or price squeeze. The terms are generally used interchangeably. During the market review ComReg considered a wholesale price control mandating either cost oriented prices or a retail minus control. ComReg concluded that either approach would achieve the regulatory objectives.

ComReg imposed the price control obligation using the retail minus approach as this is the less burdensome of the two options. Retail minus pricing also has the added characteristic that it does not seek to control the absolute level of prices but only the margin between retail and wholesale. ComReg is of the view that this control is the most appropriate for a fast growing market where demand profiles are uncertain and volume forecasts more difficult than for more established products.

The European Commission first raised the issue of potential anti-competitive problems in relation to margin squeezes in telecommunications markets in its Access Notice in 1998:

> "A price squeeze could be demonstrated by showing that the dominant company's own downstream operations could not trade profitably on the basis of the upstream price charged to its competitors by the upstream operating arm of the dominant company…. In appropriate circumstances, a price squeeze could also be demonstrated by showing that the margin

[7] In particular see paragraphs 6.114-184 in Response to Consultation and Consultation on Draft Decision Market Analysis: Wholesale Broadband Access (Response to Consultation Document 04/25 and Draft Decision) Document No: 04/83, 29 July 2004.

> between the price charged to competitors on the downstream market (including the dominant company's own downstream operations, if any) for access and the price which the network operator charges in the downstream market is insufficient to allow a reasonably efficient service provider in the downstream market to obtain a normal profit (unless the dominant company can show that its downstream operation is exceptionally efficient)."[8]

A reasonably efficient service provider in the downstream market is understood to mean a firm that is as efficient as the downstream affiliate of the vertically integrated access provider. Hence, this interpretation of a margin squeeze states that a 'squeeze' occurs when a downstream firm as efficient as the vertically integrated firm's downstream affiliate is unable to achieve a normal profit because the margin between the retail price and wholesale charge is too small. ComReg proposes to apply the "similarly efficient operator[9]" standard.

A margin squeeze applied by a vertically integrated operator having SMP in the WBA market is also a form of price discrimination, as noted in the European Regulators Group common position on the application of remedies:

> "Price discrimination can be used by a vertically integrated undertaking with SMP on the wholesale market to raise its rivals' costs downstream and induce a margin squeeze. This is achieved by charging a higher price (which usually is above costs) to downstream competitors than implicitly charged to the own retail affiliate, i.e. discrimination between internal and external provision."[10]

ComReg notes that the attraction of a retail minus control is that it avoids the possibility of a margin squeeze in a transparent and predictable manner without requiring the regulator to take a view of the appropriate absolute wholesale price level.

## 3.3 Illustrating the concept of margin squeeze

The main reason for a vertically integrated firm to engage in a margin squeeze is to gain market power in the downstream retail market. By raising the price of the wholesale input it sells to its downstream competitors, it can ensure they do not make a normal profit and, ultimately, exit the market. This will increase the vertically integrated firm's market power in the retail market, permitting it to charge a higher retail price and earn higher profits. Raising the price of the wholesale input not only puts pressure on firms currently in the retail market, but also acts as an entry deterrent to potential entrants, who realise that entry will not be profitable. The overall effect of a successful margin squeeze is to drive out current retail competitors and to deter new entry, thus ensuring no effective competition in the retail market.

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[8] EC Access Notice para 117-118, Notice on the application of the competition rules to access agreements in the telecommunications sector, OJ 1998 C 265/2.

9 Using this standard when applying retail minus ensures that firms that are less efficient than eircom are not encouraged to enter the market.

[10] Page 35, ERG Common Position on the approach to Appropriate remedies in the new regulatory framework, ERG (03) 30rev1, April 2004.

The key aspect of assessing whether a margin squeeze is being applied is to consider the difference between the retail price in the down stream market and the wholesale price of the input supplied. First, assume the downstream competitor is as efficient in the downstream sector as the vertically integrated firm. If the vertically integrated firm raises the cost of the wholesale input to the point where the total costs of its competitor (consisting of the price of the wholesale input plus its downstream retail costs) exceed the market price, then the competitor will be unable to make a profit.[11] The key issue to assess is the difference between the wholesale input's price and the price of the final good – the difference, or margin, between them is being squeezed by the vertically integrated firm.

The vertically integrated firm itself can earn profits, as its own input costs are less than the price it charges its downstream competitor. The net effect is to ensure the downstream competitor earns a loss despite being as efficient as the vertically integrated firm. This should mean that downstream rivals leave the market, while potential entrants to the downstream market are deterred from coming in. This consolidates the vertically integrated firm's position in the downstream market and allows it to charge higher retail prices. By limiting entry at the retail level, it may also help prevent future wholesale entry, as wholesale entry may be easier for firms that have established a strong retail presence.[12]

To summarise, the main criteria assessed when applying a margin squeeze test are as follows:

- There is a vertically integrated firm with SMP in the upstream market
- The margin between the retail price and the price charged for the wholesale element is insufficient to cover the vertically integrated firm's downstream costs (by implication therefore an equally efficient downstream firm would not be profitable)
- The vertically integrated firm does not incur a loss overall.

## 3.4 Incentives for a vertically integrated operator to engage in a margin squeeze

Where a vertically integrated operator has SMP in the upstream market the wholesale price of the upstream element is determined by a vertically integrated firm absent regulation. It is likely this firm would also have influence over the retail price in the final downstream market – this depends upon whether it currently has market power in the downstream market. Hence an unregulated vertically integrated firm with SMP in the upstream market can apply a margin squeeze by affecting the relative values of the wholesale and retail prices.

[11] Note that at this wholesale input price, the vertically integrated firm's downstream arm also would not make a normal profit.

[12] This is an illustration of the "ladder of investment" theory.

A vertically integrated firm could practise a margin squeeze by setting a relatively high price for the upstream element and/or a relatively low retail price, such that it leaves itself insufficient margin to cover its own downstream costs.

At this stage it is worth asking what incentive a vertically integrated firm has to apply a margin squeeze. There are two main incentives:

1. A successful margin squeeze, by ensuring downstream competitors will not make a normal profit, will force out such competitors as well as ensuring potential new entrants do not come into the downstream market. This will enable the vertically integrated firm to strengthen its position in the downstream market and charge a higher price than would result from a competitive market to the detriment of consumers.
2. High barriers to entry in the upstream market may be lowered by successful entry into the downstream market. This gives a further incentive to the vertically integrated firm: by ensuring a dominant position in the downstream market it not only obtains greater profits in that market, but helps preserve its dominant position in the upstream market, to the further detriment of end-users.[13]

One critique of margin squeezes suggests that a vertically integrated firm would not find it rational to apply them.[14] If a competing downstream firm is known by the vertically integrated firm to be more efficient at retailing a service, the vertically integrated firm would do better by selling the upstream input at a price that enables it to appropriate profits from this more efficient downstream firm. In this setting the vertically integrated firm's downstream costs exceed the costs of the entrant. If the vertically integrated firm applies a margin squeeze to exclude the entrants, it will earn lower profits than it would have if it had sold the input to the efficient downstream firm.. Therefore, it follows that the latter 'accommodating strategy' is superior. However, this argument is incomplete, as a successful margin squeeze will give the vertically integrated firm market power in the downstream market thus allowing it to raise the level of the retail price in which case a margin squeeze may well be more attractive than accommodation. And it ignores the second incentive, where a benefit from margin squeezes may be preventing the entry of rivals into the wholesale market.

Overall, ComReg analysis shows that a vertically integrated firm with SMP in the Market and which offers downstream retail broadband services faces incentives to apply a margin squeeze. ComReg notes that the more efficient the market entrant, the less incentive there would be to squeeze the margin, but that it may still occur. ComReg therefore proposes to apply an appropriate test to ensure that a margin squeeze is not applied in the Market.

[13] This is related to the "ladder of investment" theory.
[14] This is known as the Chicago critique in the economics literature.

## 3.5 Principles of ex ante and ex post application of a margin squeeze test

The application of retail minus pricing obligations by National Regulatory Authorities is therefore predicated on ensuring fair competition and the avoidance of margin squeezes.[15] Competition and Regulatory Authorities typically assess the value of margin between wholesale and retail prices and compare this value against downstream costs incurred in providing the retail service. This test is known as an *imputation test*. If the downstream retail costs exceed the margin between retail and wholesale prices it is presumed that a margin squeeze is being applied, as an efficient downstream firm could not enjoy a normal profit.

ComReg is seeking to apply retail minus in this market consistent with the objectives of promoting predictability and enhanced transparency. The control that will be applied by ComReg could apply the imputation test in either an ex ante or ex post manner. In ComReg document 04/83, which was published as part of the process of defining and analysing the Market and identifying appropriate remedies to impose on eircom, it was stated that the question of an ex ante versus ex post application of a retail minus price control would be a key feature of this consultation.

Before addressing this question in further detail it is instructive to look at the experiences to date of competition and regulatory cases where the retail minus methodology has featured.

There are several examples of the European Commission's legal approach to margin squeeze[16] via the application of Article 82 of the EU Treaty. Some commentators[17] have noted that Article 82 has been used not just to address perceived anti-competitive behaviour, but to achieve broader liberalisation objectives. For the purposes of this consultation, it can be noted that cases have included a focus on OAOs, and a focus on new market entrants. This means that in some cases, showing that a rival would (or would not) be excluded from the market was decisive in finding an unlawful margin squeeze. In other cases (notably Deutsche Telekom) the focus was on the potential exclusion of new market entrants.

ComReg has noted that a margin squeeze test can be carried out ex ante, typically before the launch of a new product or service, or ex post, where the test is applied

[15] Such tests have been applied in an abuse of dominance case involving BskyB in the United Kingdom (see Office of Fair Trading, 2002, BskyB: The Outcome of the OFT's Competition Act Investigation, December) and in the Deutsche Telekom case before the European Commission OJ 2003 L 263/9.

[16] See for example National Carbonising (Case 107-75 R, National Carbonising V. Commission, [1975] ECR 1193), Napier Brown/British Sugar ([1988] O.J.L 284/41), IPS vs Commission (Case T-5/97, [2000] ECR II-3755) and most recently Deutsche Telekom ([2003] O.J. L 263/9).

[17] See for instance John Kallaugher "The "Margin Squeeze" under Article 82: Searching for Limiting Principles" presented at the conference organised by the Global Competition Law Centre (GCLC) in association with British Telecommunications plc, BT Centre, London, 10 December 2004.

usually following a complaint. The table below summarises the advantages and disadvantages of each approach when applied to retail minus.

| **Application of retail minus:** | **Pros** | **Cons** |
|---|---|---|
| Ex ante | Can provide greater predictability for investment<br><br>Transparency in implementation and operation<br><br>Precludes potential margin squeeze | Places greater burden on regulated firm as it needs to ensure compliance<br><br>Potentially greater burden on regulator<br><br>Could result in delays in product releases due to compliance requirements<br><br>May reduce price or product innovation |
| Ex post | Provides for much greater flexibility<br><br>Less burdensome for regulated firm and for regulator | Less predictability<br><br>Less transparent<br><br>Late detection of a price squeeze could result in vertically integrated firm with market power upstream successfully deterring entry e.g. by acquiring a substantial share of new markets, which could reinforce its market power due to tipping |

ComReg's analysis in the WBA market review concluded that the market is not effectively competitive, and that regulatory intervention was required to address this. Thus, it is unlikely that ex post regulation would be sufficient to ensure that eircom does not leverage its SMP in the wholesale market into the potentially competitive downstream market. This is because ex post measures generally address the abuse of a dominant position, rather than the holding of a dominant position. Specifically in this market, this means that by the time problems associated with margin squeeze were recognised and reported, and an ex post test was carried out, market share could already be secured by a vertically integrated firm, and alternative market entry prevented. In determining that a market should be subject to ex ante regulation, the

European Commission in its Recommendation on Relevant Markets[18] has already concluded that Competition Law is insufficient to address the competition failures identified.

In considering the relative merits of ex ante and ex post application, ComReg returns to its overall regulatory objectives. Given the current situation of the broadband market in Ireland, ComReg believes that it would not yet be sufficient to rely on an ex post margin squeeze test to control market power. Were the market more mature and closer to effective competition, then an ex post test would be the appropriate way in which to test for a margin squeeze.

An ex ante approach would offer greater transparency in the market, because any proposed changes to price would be assessed for potential margin squeeze before they came into effect, using a method and a process which had already been agreed with industry. This would effectively preclude the possibility of margin squeeze. The benefit for the regulated firm is that it would know what margin squeeze test would be applied and how, and would therefore be able to ensure compliance. The benefit for OAOs would be that potential margin squeeze would be excluded, and would be seen to be excluded.

A second benefit of an ex ante approach is that it would offer greater predictability in the market. By agreeing a retail minus price control which would run for a specified period, all operators would be able to plan their product offerings and business strategies with more secure financial information

An ex ante retail minus approach would work in principle as follows. ComReg would use information about the downstream costs, possibly those associated with the vertically integrated firm, to determine the margin that would be required between revenues (prices) and the upstream costs. The vertically integrated firm would be free to choose its retail price but the maximum wholesale price would be determined by reference to a retail minus formula such that a margin squeeze would be avoided.

It is ComReg's view that ex ante measures are required to reduce the level of market power in the WBA market, and to ensure that competition becomes established. ComReg notes that the principles of transparency and predictability are paramount, and that these principles are best achieved by implementing an ex ante approach.

## 3.6 Conclusion

This section has detailed ComReg's approach to retail minus, the conclusions of which can be summarised as follows :

[18] Official Journal of the European Union, Commission Recommendation of 11 February 2003(2003/311/EC).

- The objective of implementing a retail minus price control is to ensure that an operator with SMP in the WBA market does not leverage market power into the downstream ISP market via a margin squeeze
- The application of a retail minus mechanism should be transparent
- The application of retail minus should offer all operators in the market greater predictability in terms of their investment and planning
- While a margin squeeze test can be carried out on an ex ante or ex post basis, ComReg believes that in the current market situation, regulatory objectives will be best achieved by applying an ex ante margin rule

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| **Q. 1. Do you agree with the application by ComReg of an ex ante retail minus test?** |

# 4 Calculating the required margin

## 4.1 Introduction

ComReg proposes to adopt an ex ante form of retail minus. In order to determine a retail minus control that prevents the application of a margin squeeze ComReg must analyse three elements:

- The wholesale price
- The retail price
- The downstream costs of the vertically integrated firm (adjusted to take account of a similarly efficient operator).

In this section the calculation of each of these is discussed in greater detail, and the rationale for their adoption is also discussed.

Before addressing the main components of the ex ante retail minus control, a discussion of what constitutes a similarly efficient operator and the role of dynamic issues in the application of a margin squeeze test is necessary.

## 4.2 Similarly efficient operator

ComReg proposes to use as the benchmark the concept of a 'similarly efficient operator' i.e. one which shares the same cost function as eircom's own downstream businesses but which does not yet necessarily enjoy the same economies of scale and scope as eircom's overall business currently does.

ComReg considers that the appropriate conceptual approach for the margin squeeze analysis in this situation would be to establish a margin which would allow a similarly efficient operator to enter the market today; to incur the relevant start-up costs, initial losses etc and still expect to be able to recover their costs over a reasonable period of time and to compete effectively with eircom in the broadband services market going forward. The adjustments which ComReg may make to take account of costs which are unavoidable for competitors are discussed below.

ComReg recognises that in making adjustments to costs and applying the margin squeeze framework to a similarly efficient operator, it needs to avoid promoting inefficient entry. In the longer term ComReg expects that local loop unbundling (LLU) and direct connections are likely to provide the more important basis for the promotion of competition in broadband, and is therefore concerned not to set a margin which could distort incentives to invest in infrastructure, or encourage inefficient entry.

In making the necessary judgements, ComReg will therefore take account of the effects on infrastructure investment.

**Q. 2. Do you agree that a "similarly efficient operator" constitutes an appropriate benchmark for a market squeeze analysis?**

## 4.3 Dynamic issues

In a previous section dynamic considerations were raised in relation to the incentives to practice a price squeeze. In this section dynamic issues related to the application of the test proposed by ComReg and the measurement of variables used in the test is addressed.

In a relatively new market such as broadband, unit costs are likely to change as the number of subscribers increases. ComReg believes that due to economies of scale and scope, over time unit costs should decline in real terms in this market. It is also likely to be the case that as firms acquire a better understanding of the market, unit costs will fall to reflect this (what is sometimes termed learning-by-doing).[19]

Prices may also vary over time. It is often the case, following the introduction of new products, that firms discount prices in an attempt to foster demand, partly to encourage take-up and partly to enable lower unit costs.

In applying a margin squeeze test in this market ComReg could rely on historical or current data. The benefit of doing this is certainty: the data are known. The downside of doing this is the possibility that recent data are a poor indicator for the values of variables in the future. Where such data are employed they might suggest that the ex ante retail minus test would require that the vertically integrated firm's downstream unit cost is less than or equal to the retail price minus the wholesale price. This margin could be large and may overstate current and future downstream costs and as a result would impose an unfair burden on the regulated firm. Alternatively, by using the costs of the regulated firm the value of the vertically integrated firm's downstream unit cost may be low (as this firm may already enjoy substantial economies of scale due to first mover advantages). In this case the margin could be too small and would impose an unfair burden on entrants.

Another option would be for ComReg to rely on current data and judgements about the values of variables in the future. The benefit of doing this is that the effects of scale and learning economies may be factored in, along with any effects associated with introductory offers. The costs of adopting this approach would derive from errors in the judgments formed.

As the broadband products sold in this market have a customer life-cycle of many months (typically more than twelve and possibly up to forty eight), to ensure that the setting of margins adequately performs in an ex ante fashion the margin squeeze test, it will be necessary to form judgments about the value of future costs and prices (or revenues). In addition the prevalence of scale and learning economies also favours the application of current data and judgements about the values of the relevant variables.

[19] See Kenneth J. Arrow (1962) "The economic implication of learning by doing", Review of Economic Studies, vol. 29, pp. 155-73.

ComReg believes that it is appropriate in this market to apply retail minus based on current data and judgements about future variables. However, ComReg notes that this approach may impact on the key objective of predictability.

**Q. 3. Do you agree that in this market it is more appropriate to adopt an approach which can consider future costs and revenues rather than relying on historical costs and revenues?**

### 4.4 Discounted cash flow analysis

By taking account of the market dynamics and adopting a forward looking approach to assessing costs and revenues (prices), ComReg believes that a discounted cash flow (DCF) method can be adopted to assess appropriate margins. A DCF approach is often used to assess business investment decisions. It uses the future value of cash flow projections and discounts them to arrive at a present value.  An investment is worthwhile if the sum of the DCFs is non negative.

To apply retail minus ex ante using DCF requires an assessment of margins over time, which may be set as time varying or time invariant.  Having established an appropriate margin between retail and wholesale prices, that produces non negative returns from the DCF analysis, an ex ante retail minus control is formulated that will preclude the application of a margin squeeze.

The application of the DCF method would be undertaken by ComReg by assessing the profitability of a similarly efficient operator to eircom, using data from eircom but making appropriate adjustments to account for the evolution of future prices and costs specific to a new entrant. The DCF approach will be employed in such a way so that the similarly efficient operator obtains a non-negative return over some defined period. Having ensured this outcome, the model will inform ComReg of the appropriate margins.

Applying a DCF method using forward looking assessments for the relevant variables requires judgments to be made about costs and revenues, as well as about the appropriate cost of capital.

A DCF approach seems to be the most appropriate tool in the circumstances and has the virtue that it is widely understood and used in business planning for analysing capital investment projects where the returns are realised over a number of time periods.

ComReg is proposing to apply DCF analysis by considering the position of an entrant today. In applying this approach, ComReg proposes to use eircom’s costs – both historic and forecast data – as a data source. However, ComReg proposes to apply adjustments to these data, as discussed in more detail below.

A complication of this approach arises in terms of how best to determine the appropriate margin. In the following sections both the treatment of variables over time and the setting of the margin is discussed.

**Q. 4. Do you agree that a DCF method should be used to assess margins?**

## 4.5 What time horizon?

In assessing the profitability of a similarly efficient operator, there are a number of approaches for dealing with assessing profitability over time. For example, the profitability of the key current investments would imply using the economic life of those assets. Alternatively a very long-run approach which would consider profitability over the whole lifetime of the business or at least over multiple investment cycles could be employed.

Inevitably there is a trade-off between reliability and the horizon chosen. The longer the horizon, the more demanding the forecasting exercise and the more unreliable the forecasts – particularly as it would require the formation of judgments about future technologies.

Given the considerable difficulties associated with taking a very-long run approach with services which are still developing, as is the case here, ComReg proposes to adopt an approach used by other NRAs which focuses on the nature of the underlying investments and an appropriate period for the recovery of those investments.

ComReg considers that an appropriate timescale would be one under which the current investments were profitable and where the firm did not rely on earning super-normal profits on future investments. On this basis, ComReg considers that it would be more reasonable to specify a time period that was related to the economic life of the underlying assets rather than the very long-run.

ComReg could choose a shorter time period but this would run the risk that it would not allow sufficient time for an entrant to recover early year losses, resulting in an inflated margin in order to pass the margin squeeze test, and thus encouraging inefficient entry. Conversely, a longer time period places reliance on forecasts for an extended period into the future, increasing the risk of forecast error and the likelihood of generating unreliable results.

Mindful of the need to balance these two concerns, ComReg considers that it is reasonable to carry out the DCF analysis over a five year period and truncate the analysis at that point with the inclusion of terminal values. ComReg believes that this provides sufficient time for an entrant to recover any legitimate initial losses whilst taking account of issues around reliability of forecasts in that the analysis uses both data from eircom’s actual experience as well as eircom’s updated forecast data.

**Q. 5. ComReg proposes to carry out the DCF analysis over five years. Do respondents agree?**

## 4.6 Terminal value

ComReg proposes to apply the DCF analysis for five years and truncate at that point instead of trying to project the cash flows to infinity. The standard approach for dealing with such truncation is to consider the terminal value associated with the activity at the time of truncation to reflect the fact that the business will continue beyond this time and that assets have an on-going economic value (or earning power).

The approach which ComReg proposes will allocate the costs of assets to be recovered (including cost of capital) between two periods of time: the explicitly-modelled period of five years from launch up to the point of truncation and the years beyond the point of truncation. The smaller the terminal value is, the greater the amount of cost to be recovered in the explicitly modelled period.

**Q. 6. Do you agree that it is appropriate to apply a terminal value? If so, what do you believe would be an appropriate method for calculating this value?**

## 4.7 How often should the margin be reassessed

ComReg has considered whether the retail minus control should be invariant over a fixed period, and if so, how long. Further, ComReg has considered the circumstances which would trigger a review.

In considering the period over which the control should apply, ComReg has examined a range of options. One option would be to review the appropriate margin every time there is a retail price change. While this would ensure that the control was highly responsive to the market, and that any changes in product or service offering could be accommodated, ComReg considers that this approach could not provide the level of predictability which is required by all operators. As the provision of greater certainty as regards the margin is a key purpose of proposing this measure, ComReg does not believe that a margin review triggered each time there is a retail price change would achieve the regulatory objectives.

Another option would be to fix the margin for a multi-year period, perhaps by linking the margin review with the next market analysis of the WBA market. The advantage of this approach is that at this time ComReg will revisit the issues of market definition and its assessment of market power. ComReg will also have the opportunity to assess whether the remedies imposed as a result of the first market review have been effective and proportionate in addressing SMP in the WBA market, and to examine the level and nature of market entry.

However, while this approach would have appeal in a market which was mature and fairly predictable, ComReg is concerned that a fixed margin applied over a multi-year period may not be the best option in a dynamic and new market. ComReg notes that other regulatory interventions, such as Local Loop Unbundling (LLU) are likely to impact on the WBA market over the next few years. While a longer term fixed margin would deliver greater certainty for operators, the lack of responsiveness to change would be a major disadvantage.

In order to balance the provision of greater certainty with the need for flexibility, ComReg therefore proposes that the retail minus control should be subject to annual review to ensure that it is providing the appropriate margin. ComReg notes that an overall analysis of the principles underpinning the setting of a retail margin will form part of the next market review of the WBA market, and that this process may take precedence in the review timetable. Further, ComReg would wish to retain the flexibility to initiate a review of the margin should circumstances in the market change significantly.

**Q. 7. Do you agree that the margin should be subject to annual review, unless triggered by significant change in the market?**

## 4.8 What discount rate should be applied?

In the DCF exercise ComReg will need to apply a discount rate. ComReg proposes that it would be appropriate to use a measure of the weighted average cost of capital (WACC). This may be applied on a pre-tax or post-tax basis. Eircom currently applies a pre tax WACC of 11.5% in its separated accounts.

ComReg therefore proposes to use eircom's cost of capital as a basis for calculating the relevant discount factor in the DCF analysis.

**Q. 8. Do you agree that eircom's cost of capital should be used as the basis for calculating the discount factor in the DCF analysis?**

## 4.9 Individual services or a portfolio?

It is possible to carry out a margin squeeze analysis at the whole business level, i.e. across a portfolio of related products and also at the level of individual products and services.

eircom currently provides a number of retail ADSL products. Each of these retail products has a corresponding wholesale bitstream product. Of course entrants are also likely to offer a portfolio of services and could choose to compete with eircom across a similar product portfolio. However, it seems premature for ComReg to make judgments about the nature of entry. ComReg's margin squeeze testing to date has been based on the price differential between each of the retail products and its equivalent wholesale product.

ComReg recognises that the main benefit of conducting a margin squeeze test across a portfolio of products is that it offers the operator greater flexibility in designing its offerings, and consequently could lead to greater innovation in the market. However, a portfolio approach is necessarily less transparent, and risks an operator squeezing the margin on one product while remaining within the overall balance of the portfolio.

ComReg proposes to apply the ex ante retail minus framework on a product by product basis rather than on a portfolio basis. Ensuring that there is no margin squeeze on any individual product should avoid an entrant having to replicate eircom's product mix in order to be viable. Conducting the margin squeeze at the level of the individual product would allow OAOs to enter the market and target specific retail segments. If the analysis was performed on a portfolio basis eircom could potentially cross subsidise between retail products such that addressing certain segments in isolation would be unattractive.

**Q. 9. Do you agree that the margin squeeze test should be conducted on the basis of individual products?**

## 4.10 Wholesale products without retail equivalents

In addition to the wholesale products that eircom uses to support its own retail products and services it also offers two wholesale products which its own retail arm does not avail of. ComReg document 05/11r imposes upon eircom an obligation to meet reasonable requests for wholesale bitstream products and therefore it is possible that additional products will be developed at the wholesale level which eircom will not use at the retail level. As eircom does not offer retail equivalents of these wholesale products, the application of a retail minus price control would clearly be impossible.

ComReg proposes that wholesale products, without an equivalent retail product offered by eircom, should be excluded from the margin squeeze analysis. In order to avoid distorting the market, ComReg believes that these products should be priced in a manner consistent with the nearest equivalent wholesale product (which eircom does avail of at the retail level) suitably adjusted to reflect differences in functional characteristics.

**Q. 10. Do you believe that this is an appropriate way to treat wholesale products which eircom does not avail of at the retail level?**

## 4.11 Retail Prices (Revenues)

A key element of the DCF analysis in an ex ante margin squeeze test is the prices of the downstream services, which generate the revenues. As the DCF exercise is forward-looking, ComReg will need to assess the likely path of costs and revenues for a similarly efficient operator to eircom. It is important when doing this that ComReg does not include the effect on revenues of the application of market power.

If a similarly efficient operator were to generate positive returns in the future due in part to its ability to exercise market power, it would be incorrect to include this in the margin calculations. Therefore the assessment of revenues will be based on the presumption that the market will become effectively competitive in future years.

ComReg starts from the assumption that in a competitive market, a large fall in costs would generally be expected to lead to lower prices, though this may not occur immediately. However, it seems unreasonable to suppose that firms could maintain prices above costs indefinitely in the face of competition.

ComReg believes that real unit costs in this market are likely to fall, rather than increase, over time, and that competition among providers would reduce prices. ComReg proposes to conduct sensitivity analysis when evaluating margins to assess the impact of competition on prices.

**Q. 11. Do you agree that ComReg should perform sensitivity analysis around rates of decrease of retail prices in doing its DCF evaluation of margins?**

## 4.12 How should we approach costs?

ComReg has considered whether it is more appropriate to use historical costs or projected costs when assessing the cost of offering service. Generally, historical costs would look at actual costs over a specified period. Standard accounting techniques would be used to analyse costs and assess profits. This approach would normally be used where there is reliable time series data on which to base projections, and where the market is reasonably stable, so that past performance can provide a reasonable guide to future performance.

The WBA market in Ireland does not exhibit the characteristics which would tend towards adopting a historical costs approach. The market is relatively new, subject to potentially rapid change, and is not likely to develop stability in the short to medium term. An alternative approach to the accounting-based focus on historic costs is to adopt a forward looking approach which analyses economic costs and revenues over time. This approach would be standard practice in business planning, and ComReg considers that, given the characteristics of the WBA market in Ireland, the most appropriate approach is to utilise a forward looking assessment of economic costs and revenues.

**Q. 12. Do you agree that it is more appropriate to adopt a forward-looking approach to the assessment of costs?**

### 4.13 Whose costs?

The key aim of an ex ante retail minus rule to apply a margin squeeze test is to ensure that similarly efficient operators to eircom are able to compete and build a profitable business.

ComReg notes that a competition analysis approach would use eircom's costs in calculating the margin. The analysis would assess the level of downstream profitability which eircom could expect assuming it paid the same wholesale price as its competitors. This means that the calculation would be of the additional costs which eircom incurs in order to offer its retail products. These are incremental costs. While this approach has some appeal – notably that eircom's costs are known and reported – the disadvantage is that it cannot take into account costs which a new entrant would incur, but which eircom would not.

An alternative approach would be to start from the costs which would be borne by a new entrant to the market, and to build a bottom-up model of a new entrant's costs. While this may appear to be a more realistic measure of the actual experience of a new market entrant, ComReg believes that the cost assessment is more reliable if built on actual costs rather than hypothetical costs, and that eircom's cost profile provides the best starting point for the analysis. ComReg notes that this is consistent with practice of other NRAs, and with recommendations from the EC and ERG.

ComReg's proposed approach is to set a margin which would allow an entrant of *similar efficiency* to eircom to enter the market and compete on a forward looking basis. In ComReg's view, this means that costs necessarily incurred by a new entrant but not by eircom should be incorporated into the analysis. However, it must be emphasised that new entrant costs must be considered carefully to ensure that there is no reward for inefficient entry.

ComReg's proposal is therefore that eircom's costs are used as a starting point for the assessment, and that they are modified to take account of costs borne by similarly efficient new entrants.

**Q. 13. Do you agree that eircom's costs should be used as the basis for establishing the costs of a similarly efficient operator?**

# 5 Implementation of the control

ComReg is proposing to implement an ex ante retail minus price control. In this section, ComReg puts forward its proposals for the practical application of a retail minus control. There are three elements that ComReg will consult upon in this section. These are:

- the process for assessing compliance of wholesale prices with a retail minus control,
- the form of the retail minus price control; and
- the process of notifying OAOs of wholesale price changes.

In the sections below ComReg proposes a number of new time lines associated with the introduction of new products and amendments to existing products. These timelines relate solely to the wholesale price control obligation. eircom has a number of other obligations, including the obligation to provide access and the obligation to behave in a non discriminatory manner. Compliance with these obligations may have implications for the timings around the introduction of new products or amendments to existing products above those set out in the price control.

## 5.1 Assessment of compliance

In order to assess compliance with a retail minus price control, ComReg will clearly require visibility of both retail and wholesale prices, and as ComReg is proposing an ex-ante control, ComReg will need to have visibility of changes in retail or wholesale prices prior to their implementation. ComReg has not defined a retail broadband market that is suitable for ex-ante regulation and is in no way seeking the power to regulate retail prices. Any notification to ComReg by eircom of retail price changes in advance of their implementation is solely for the purpose of assessing compliance with the wholesale price control. Should ComReg find eircom to be non compliant with the wholesale price control, any regulatory interventions by ComReg would relate only to wholesale prices.

ComReg believes it would be undesirable if a lengthy approvals process were to delay innovation in the market place. It is in the best interests of all operators and consumers that product and service innovation be encouraged and ComReg will seek to ensure that any mechanisms put in place cause the minimum delay. ComReg recognises that eircom should be encouraged to innovate and must be allowed to respond to price changes by other operators in the retail market. There is a need to strike a balance between protecting competitors in the downstream market from the possible application of a margin squeeze and enabling the vertically integrated SMP operator to compete fairly in the downstream market.

ComReg has considered whether eircom should be required to submit proposed retail and wholesale price changes to ComReg in advance of their implementation, so that ComReg can assess whether the proposed wholesale prices are compliant with the wholesale price control. Where eircom wishes to implement a change in the retail price of one of its existing products (including amendments to promotions), ComReg believes that the application of a retail minus formula is a sufficiently transparent mechanism that compliance with the obligation should be readily determined.

Therefore, ComReg proposes that in advance of eircom making a retail price change, it should be obliged to issue ComReg with a statement of compliance setting out the precise nature of the retail price change. The statement should demonstrate the corresponding adjustments which will be made to the wholesale prices such that compliance with the obligation is achieved. Once eircom has submitted such a statement to ComReg, it would be free to immediately notify wholesale operators of the wholesale price change as set out in Section 5.3 below without awaiting formal approval from ComReg.

In these circumstances, ComReg would only intervene if it found that the proposed changes in retail and wholesale prices were not in compliance with the price control obligation. If the proposed changes were not in compliance, ComReg would either initiate enforcement proceedings or direct amendments to the wholesale prices.

**Q. 14. Do you agree that in the case of amendments to prices of existing products (including amendments to promotions) it is sufficient for eircom to issue ComReg with a statement of compliance and simultaneously notify wholesale prices to other operators ?**

In the case where eircom introduces new retail products, whether by changing the technical specifications of the product or by changing the basis of pricing[20] of the products, the assessment of compliance with the obligations will necessarily be less clear cut than is the case of amendments to existing products. There is a tension between the desire for transparency in the wholesale price control and the need to retain flexibility so as not stifle innovation. ComReg believes that it would be impractical to try and create a wholesale price control that accommodated all potential innovations at the retail level in advance of their introduction. Therefore, ComReg believes that in order to prevent a potential margin squeeze it would not be sufficient to adopt the same assessment process as proposed for amendments to existing products in the case of the introduction of new products.

In selecting the assessment procedure associated with the wholesale price control, ComReg should seek to ensure that it does not stifle innovation and cause unnecessary delays to the introduction of new products. ComReg has considered whether it would be appropriate to set a fixed time limit in which it would consider the compliance of new products. However, ComReg sees two disadvantages to this approach. On the one hand, as it is impossible to anticipate all future developments, it may not be possible to complete all assessments within a defined period. On the

[20] For instance, ComReg regarded the introduction of eircom's time based retail product (with its associated wholesale product) as a new product because although it had the same technical specification as the pre existing flat rate product, it was a significantly different tariff structure.

other hand, a fixed time period may in fact slow the introduction of new products where the assessment turns out to be relatively straightforward.

ComReg has also considered whether it would be appropriate to make no commitment about the time taken to complete the assessment of new products. ComReg believes that this would create unnecessary and undesirable uncertainty in the market.

Therefore, ComReg proposes that prior to the introduction of new products, eircom submits to ComReg a proposal setting out precise details of the new retail product and of the corresponding wholesale product[21]. Within a period of five working days ComReg will revert to eircom, either confirming that the proposal is in compliance with the obligation in which case eircom may proceed immediately to notify wholesale operators as set out in Section 5.3, or informing eircom that further analysis to determine compliance of the proposal is required and setting out indicative timelines for that further analysis. During the five days subsequent to eircom making a proposal to ComReg or during a period of further analysis, eircom will be prevented from introducing new wholesale products.

ComReg would approve the new wholesale prices once it is satisfied that the margin between retail and wholesale prices is sufficient to avoid a margin squeeze. Having determined the appropriate relationship between retail and wholesale prices for the new products, ComReg would update the retail price mechanism such that any subsequent amendments to the prices of these products would be assessed using the mechanism set out for existing products.

**Q. 15. Do you believe that this proposal for price changes to new products is an appropriate mechanism for assessing the compliance of new products?**

## 5.2 Form of retail minus price control mechanism

The wholesale bitstream service is composed of a number of elements, such as connection fee, monthly rental, usage fees, cessation, backhaul and service establishment. ComReg is proposing that the retail minus price control should only apply to the connection and monthly rental elements of the service.

In Section 4 of this document, ComReg has acknowledged that there are fixed and variable elements to the cost stacks associated with the retail bitstream products. It has advocated a DCF analysis for a defined period in order to take relevant account of the intricacies of the cost stacks and the product life cycle. Prior to receiving the responses to this consultation and completing this analytical work, ComReg believes

[21] Where eircom introduces a new retail product that is not adequately supported by the existing wholesale product set, eircom will be required to introduce a new wholesale product providing equivalent functionality and or tariff structure.

that it would be premature to consult on the appropriate size of the margin required for the wholesale price control.

However, ComReg believes that in the interests of transparency it is appropriate to consult on the form of the price control and to seek interested parties' views on whether ComReg proposals satisfy the requirements for transparency, predictability and flexibility while avoiding the possibility of margin squeeze during the life of this control.

### *5.2.1 Price control on Connection fee*

ComReg believes that the wholesale connection fee should always be cheaper than the standard (i.e. excluding temporary promotions or discount schemes) retail connection fee. Therefore, ComReg proposes that the wholesale price control for the connection fee should take the following form:

***Wholesale connection fee = Standard retail connection fee * fixed percentage(<100%)***

The treatment of temporary promotions and discount schemes are addressed later in section 5.2.3 and 5.2.4 below.

**Q. 16. Do you believe that this is an appropriate form of price control for the connection fee?**

### *5.2.2 Price control on wholesale monthly rental*

The primary purpose of imposing a retail minus price control is to avoid a margin squeeze. ComReg hopes that the price of bitstream will continue to reduce over time as the take-up of the service increases. The wholesale price control should not be an unreasonable impediment to the reduction of retail prices over time, and should have sufficient flexibility to accommodate significant reductions in the retail price. On the other hand, it is vital that as retail prices decline, adequate margins are maintained for competing operators.

In light of these objectives, ComReg has considered three different mechanisms for the wholesale monthly rental price control.

The first option that ComReg considered is where the margin is expressed as an absolute fixed monetary value. This means that the gap between retail prices and wholesale prices is a fixed monetary value. This method was employed by ComReg during the interim period.

While ComReg believes that this was the appropriate control for an interim period, prior to the completion of this consultation and its associated analysis, it did not and does not believe that this would be an appropriate basis for a permanent price control. While a price control of this form has the advantage of preventing any decrease in the margins available to OAOs (which was the objective in the interim period), it does not seem appropriate going forward in the context of reducing retail prices and increasing volumes. By expressing the retail minus as an absolute value, there is a significant risk that an artificial price floor could be created at the wholesale level if the price were to remain above cost. This could potentially stifle expansion in this market at the retail level. Alternatively, the wholesale price could be forced below cost which would place an unfair burden on eircom and would distort the investment incentives for this product as well as other wholesale products such as unbundled local loops.

The second option that ComReg considered is to express the margin as a fixed percentage of the retail price. This scenario has the advantage of increased flexibility in terms of product pricing. However, there is a risk that if the retail prices are dramatically reduced the corresponding margin, while maintained in percentage terms, will be reduced in absolute monetary terms to such a degree that there is a margin squeeze. ComReg's preliminary analysis of the costs associated with providing retail service in this market suggest that a significant number of unit costs are unlikely to reduce significantly as prices decline and volumes grow. In order to ensure that sufficient margin is maintained, if prices were to fall significantly, there is a risk that margins for the current prices would have to be set too high.

Finally, the third option considered by ComReg is a combination of a fixed monetary value and a fixed percentage. ComReg advocates this third option which lies between the two extremes examined above. This approach while avoiding a margin squeeze also takes into account the evolving nature of this market. ComReg acknowledges that prices are set to decrease over time as the corresponding volumes increase. Using a hybrid formula the absolute monetary value of the margin will decline but the percentage margin will increase. Such a hybrid approach also balances flexibility with transparency and predictability for all market players. ComReg's proposed control would therefore be:

***Wholesale rental price = (Retail rental price * fixed percentage <100%) – fixed monetary value***

ComReg proposes to set retail minus controls, in accordance with the formula above for all current products. These controls would be applied by reference to the standard retail rental i.e. excluding promotions and discounts. The treatment of promotions and discounts is discussed below in sections 5.2.3 and 5.2.4.

If eircom were to change any of the characteristics of either its retail or its wholesale products during the period of the control, it would be required to follow the approval and notification processes set out in Sections 5.1 and 5.3.

Where usage charges make up a significant portion of retail or wholesale prices (such as eircom's 'time' and 'kronos') ComReg proposes to convert usage charges into average monthly revenues (at retail and wholesale levels) and then apply retail test to the average recurring revenues.

**Q. 17. Do you think that is an appropriate way to apply the retail minus formula? If you feel that there is a superior formula, please provide your reasoning.**

### *5.2.3 Retail Discount Schemes*

eircom currently has one retail discount scheme – the Bulk Connection Discount Scheme. This provides discounts on the self install connection charge for bulk orders for DSL service. It is available for eircom's retail DSL products other than eircom Broadband Home Starter. There are a number of discount levels depending on the size of the order.

It is proposed that if eircom makes any changes to this discount scheme, during the relevant control period, then ComReg may require corresponding changes to wholesale bitstream prices. ComReg proposals would be carried out in accordance with the assessment process proposed for amendments to existing products.

Where eircom wishes to amend or introduce a new discount scheme, ComReg proposes that it would be subject to the same assessment process as outlined for new products.

**Q. 18. Do you think that this is an appropriate way to treat discounts?**

### *5.2.4 Retail Promotions*

eircom may from time to time introduce temporary promotions. In such circumstances, ComReg believes that controls on promotions are necessary in order to avoid the damaging effects of a margin squeeze on competition in the provision of retail DSL services. For many new customers the margin on the standard product will be irrelevant because they have taken up DSL under a promotion. This is particularly important for this market because of the extensive use of promotions to sell DSL products where eircom adopts a policy of near continuous, but varying, promotions.

Given the frequency with which new promotions are introduced at the retail level, ComReg believes that it would be undesirable to amend the wholesale prices every time a new retail promotion was introduced or withdrawn. Therefore, ComReg proposes a continuation of the current arrangement whereby each retail promotion is matched by a corresponding wholesale promotion, the value of which is computed by assessing the revenue foregone at the retail level between the promoted prices and the standard prices. This wholesale promotion takes the form of a one off rebate payment.

ComReg will treat any retail promotions and their corresponding wholesale promotions relating to existing products (including extension of deadline or early withdrawal) in the same way as it would for the assessment of price changes of existing products as set out in Section 5.1.

**Q. 19. Do you believe that this is an appropriate way to treat promotions? If not, please state clearly the reasons for your disagreement.**

### *5.2.5 Other Price Controls*

There are currently a range of other bitstream related wholesale charges and services that are not so amenable to a retail minus control, mainly because they do not have direct retail equivalents. The approach to controlling prices for each of these additional services is set out below.

#### 5.2.5.1 Service Establishment Charge

eircom currently sets a service establishment charge of €8,035 per Access Seeker and aims to recover eircom's costs in providing authorisation and training in bitstream IT systems for Access Seeker staff. ComReg proposes that eircom make no increase in this charge, or changes to other terms or conditions, without prior approval from ComReg. ComReg would expect to give approval where there is an appropriate cost-based justification.

ComReg proposes that this charge will be reviewed prior to the commencement of each new price control period.

#### 5.2.5.2 Cessation Charge

eircom currently sets a wholesale cessation charge of €60 per port. This charge does not apply to Access Seekers who agree to amendment of their contracts to reflect a minimum 6 month term for each bitstream subscriber port. ComReg proposes that eircom should make no increase in this charge, or changes to other terms or conditions, without prior approval from ComReg. ComReg would expect to give approval where there is an appropriate cost-based justification.

#### 5.2.5.3 Bitstream Connection Service

ComReg stated in the previous consultation that it believed that the prices for the bitstream connection services should be based on FL-LRIC costs. However, ComReg has reconsidered this position in light of the constructive engagement between eircom and access seekers in developing new backhaul products. Therefore, ComReg proposes that it would be appropriate to forbear from imposing specific obligations on these services other than that access to these services should be at reasonable prices.

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| **Q. 20. Do you believe that this is an appropriate way of treating the service establishment charge, cessation charge and bitstream connection service?** |

## 5.3 Publication / notification to the wholesale market

ComReg believes there is the potential for a retail minus mechanism to give eircom's retail operation an unfair advantage in the market, in that they know that any change they make to retail prices will automatically trigger a change in the wholesale price. However, if a competing operator were to make a price reduction it would continue to pay the same wholesale price, and hence would have lower margins. To prevent this effect from distorting competition, ComReg believes that it is essential that prior to eircom making any retail price change that would cause a change in the wholesale price, eircom must notify customers of its wholesale bitstream services in advance of the imminent wholesale price change.

The purpose of this requirement is to give OAOs time to consider their retail offer, given changes in the wholesale prices. ComReg has to consider how long the period between notification and implementation of the wholesale prices should be. In reaching an assessment of an appropriate period, ComReg has balanced the need to give OAOs sufficient time to respond to changes of wholesale prices with changes to retail prices with the desire to avoid creating unnecessary impediments on eircom's flexibility. While it is reasonable that in the current state of the market there should be some advance notification of wholesale changes, ComReg does not propose changing the notification period from the current obligation of 15 working days and does not believe that a longer period is required for OAOs to develop products and services.

ComReg notes that the prime objective of advance publication of proposed wholesale price changes is to enable the purchasers of wholesale bitstream to adjust their retail offer, should they so wish. It is therefore a matter to be addressed in the wholesale market, and the wholesale market comprises eircom and OAOs who purchase bitstream services. Given this, ComReg considers that it may not be necessary to widely publish proposed changes to wholesale prices, and that the objective may better be served by direct communication between eircom and OAOs.

ComReg proposes that OAOs should be notified by eircom of proposed changes to wholesale prices 15 working days before they come into effect. There should no longer be a requirement for general publication of proposed changes.

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| **Q. 21. Do you agree with ComReg's proposal that changes to wholesale prices should be notified to the wholesale market 15 working days before coming into effect?** |

# 6 Regulatory Impact Assessment ('RIA')

In deciding on the precise implementation of the retail minus price under consultation, ComReg will take careful consideration of the impact of its proposals on affected parties.

Previously, ComReg has undertaken a rigorous and detailed review of the WBA market. In that review ComReg designated eircom with significant market power and identified a number of competition problems, including the serious risk of eircom foreclosing the potentially competitive retail market by leveraging its market power in the wholesale market into the retail market. In order to remedy this competition problem ComReg imposed an obligation of a wholesale price control. When imposing the price control ComReg considered whether the obligation should be to have cost oriented wholesale prices or whether wholesale prices should be set by reference to a retail minus formula that precluded the possibility of a margin squeeze.

ComReg concluded that either obligation would achieve the regulatory objective of preventing eircom from leveraging its market power into the retail market, and selected the retail minus approach as it was the less burdensome of the available remedies. The obligation for a wholesale price control based on retail minus was extensively consulted upon prior to its imposition, and ComReg conducted a RIA as part of the market review process. Therefore, the regulatory impact of imposing a retail minus control is beyond the scope of this RIA exercise.

The RIA conducted here examines the relative impacts of the different choices relating to the implementation of the retail minus control discussed above. For instance, it discusses the costs and benefits of an ex ante control compared to an ex post one. It does not consider every possible choice of how to implement the control, but, in keeping with the principle of proportionality, concentrates on the more important aspects. Tabulated below is a framework that ComReg proposes to use to evaluate the impact on affected parties of the various choices ComReg will have to make in implementing the retail minus wholesale price control. ComReg seeks respondents' views on the proposals set out below. The effects on eircom, other operators, and consumers are considered. ComReg does wish to stress the substantial benefits it believes will accrue to competitors from measure than protect and enhance competition, both in terms of the immediate effect on prices, but particularly on the long-term benefits of lowering costs and enhancing innovation.

## 6.1 The effect of key proposals from the consultation on the interested parties

1. The control is in the form of an ex ante retail minus formula.

| Proposal / Alternative | eircom | OAOs | Consumers |
|---|---|---|---|
| **Ex ante** | Higher cost of compliance | Greater certainty and predictability in the | No margin squeeze should ensure |

| | | | |
|---|---|---|---|
| | Possible lack of flexibility could limit innovative pricing | market<br><br>Very low risk of being margin squeezed | competition and lower prices in retail market<br><br>Increased certainty and predictability should encourage investment and dynamic competition with long-run benefits for consumers |
| **Ex post** | Lower cost of compliance<br><br>More flexibility on the timing of the introduce new products | Less transparency and predictability<br><br>Some risk of margin squeeze being successful due to delay in implementing ex post control<br><br>Less surety as to future margins | Increased risk of successful margin squeeze may lower competition |

2. The margin squeeze test will be reassessed annually to ensure that the assumptions made in the DCF analysis are accurate, and that the coefficients of the formula are amended if necessary.

| Proposal / Alternative | Eircom | OAOs | Consumers |
|---|---|---|---|
| **Reassess more frequently than annually** | Greater cost of compliance<br><br>More likely to reflect changing market and cost conditions | Less certainty in the market<br><br>More likely to reflect changing market and cost conditions | Limited effect |
| **Reassess less frequently than annually** | Lower cost of compliance<br><br>More likely to reflect changing market and cost conditions | More certainty in the market<br><br>Danger of not accurately reflecting changing market conditions | Limited effect |

3. Each wholesale product will have an individual price control formula

| **Proposal / Alternative** | **eircom** | **OAOs** | **Consumers** |
|---|---|---|---|
| **Individual product** | Higher cost of compliance<br><br>May limit flexibility pricing | Greater certainty in the market<br><br>More likely to ensure key products not subject to margin squeeze | More likely to ensure no successful margin squeeze and hence ensure competition |
| **Portfolio of products** | Lower cost of compliance<br><br>Greater flexibility of pricing | Less certainty in the market<br><br>Possibility that OAO could be squeezed on one or two key products | May limit flexibility of supply responses to changing consumer demand |

4. Where eircom wish to introduce a new retail product it will be required to submit a proposal to ComReg for an assessment of a margin test prior to notifying OAOs of the impending wholesale change.

| **Proposal / Alternative** | **eircom** | **OAOs** | **Consumers** |
|---|---|---|---|
| **Assessment of compliance in advance of wholesale notification** | Grater cost of compliance<br><br>May slow down introduction of new wholesale products | Degree of certainty, transparency and predictability<br><br>Competition problems remedied | Benefits of competition |
| **Statement of compliance with simultaneous wholesale notification** | Lower cost of compliance<br><br>Increase speed of introduction of new wholesale products<br><br>Possible disruption if new wholesale products had to be amended / withdrawn | Greater uncertainty, less transparency and less predictability<br><br>Possible disruption if new wholesale products had to be amended / withdrawn | Less competition<br><br>Quicker introduction of new products |

5. Before implementing any wholesale price changes, including allowing eircom retail to avail of the product, eircom must notify OAOs 15 working days in advance. This notification should be restricted to those OAOs with bitstream contracts and should not be publicly available.

| Proposal / Alternative | eircom | OAOs | Consumers |
|---|---|---|---|
| **Advance notification period of 15 working days to OAOs** | Loss of automatic first mover advantage<br><br>No advance public speculation (as only current wholesale customers are obliged to be informed) | Greater certainty and predictability<br><br>Greater chance to react to competitive change in market | By ensuring equality of treatment should ensure greater competition in retail market<br><br>May limit price flexibility and responsiveness |
| **No notification period** | Greater flexibility in pricing | Can place at competitive disadvantage | May limit competition |

# 7 Submitting Comments

All comments are welcome, however it would make the task of analysing responses easier if comments were referenced to the relevant question numbers from this document.

The consultation period will run from 19 August 2005 to 16 September 2005 during which the Commission welcomes written comments on any of the issues raised in this paper.

Having analysed and considered the comments received, ComReg will review the subject matter of the consultation and the submissions and publish a report in October 2005 on the consultation which will, inter alia summarise the responses to the consultation.

In order to promote further openness and transparency ComReg will publish all respondents' submissions to this consultation, subject to the provisions of ComReg's guidelines on the treatment of confidential information – ComReg 05/24

**Please note**
ComReg appreciates that many of the issues raised in this paper may require respondents to provide confidential information if their comments are to be meaningful.

As it is ComReg's policy to make all responses available on its web-site and for inspection generally, respondents to consultations are requested to clearly identify confidential material and place confidential material in a separate annex to their response

Such Information will be treated subject to the provisions of ComReg's guidelines on the treatment of confidential information – ComReg 05/24

## Appendix A – Legislation

European Communities (Electronic Communications Networks and Services) (Framework) Regulations 2003 (S.I. No. 307 of 2003)

European Communities (Electronic Communications Networks and Services) (Access) Regulations 2003 (S.I. No. 305 of 2003)

Directive 2002/21/EC of the European Parliament and of the Council on a common regulatory framework for electronic communications networks and services

Directive 2002/19/EC of the European Parliament and of the Council on access to, and interconnection of, electronic communications networks and services

Communications Regulation Act 2002

## Appendix B – Consultation Questions

All Consultation Questions must be listed here. This can simply be done by positioning below and selecting F9 to update after you have completed your document. In order for questions to be automatically listed here they must be style Q.1. ComReg Question.

### List of Questions