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Common cost recovery and CEI access pricing

A note for ComReg

NON CONFIDENTIAL

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1 Introduction

This note considers ComReg's approach to the recovery of Eir's common costs across copper services and the potential implications for CEI (civil engineering infrastructure) access charges.

Common costs within the Intervention Area

A key concern, raised by a number of respondents to both the CEI and ANM (access network model) consultations, was ComReg's proposed approach to allocating common costs. In the ANM Draft Decision (20/101), ComReg maintained the view that the relatively high incremental cost in the NBP Intervention Area (IA) means that this is an 'uneconomic' area which should not contribute to recovery of corporate overheads common across all of Eir's activities. This maintained ComReg's previous position from 2018 (set out in ComReg D11/18).

For similar reasons, a proposal was made in the CEI consultation not to set a markup on CEI access charges in the NBP intervention area for recovery of common costs. The primary concern here was that historically copper services in the IA had not been recovering a contribution to Eir's common costs. To start doing so now through a markup for CEI access within the IA would have knock-on effects on the complementary Commercial Area (CA). In the long run, the CA would recover a smaller part of common costs, leading to lower prices for access and/or wholesale services. In turn, this would risk of distortion to incentives for competition provision, which is feasible in at least parts of the CA.

Cross-subsidy vs. differential common cost recovery

Some respondents to these two consultations alleged that not recovering common costs from the IA would give rise to a cross subsidy from services in CA to the IA. As explained below, this criticism is incorrect. Policies, both in respect of WLR pricing and CEI access pricing, that do not recover common costs in the IA are justified because of the inability of services within the IA to make a common cost contribution due to their higher incremental costs. The evidence suggests that copper services within the IA have not, nor could, make such a contribution to recovery of common costs.

Different services making different contributions to common cost recovery is not in itself a cross-subsidy. A cross-subsidy arises where a service does not cover its incremental costs and a contribution is made through a margin earned through other services priced above their incremental cost. Within the ANM, copper services are required to recover their incremental costs and ComReg has revised its treatment of common costs to ensure that incremental costs are not misclassified as common costs.

Respondents' claims of a cross-subsidy appear to be based on a misplaced presumption that Eir's common costs must necessarily be recovered uniformly across the CA and the IA. This is not the case, either as a matter of principle or historic practice, as previously ComReg has not sought to recover common costs from uneconomic services.

Under the NBP, there will be a progressive roll-out of a fibre network across the IA. Customers for current copper services will, over time migrate to the more capable fibre services, both within the IA and elsewhere, reducing the volume of copper services demanded. Eventually, copper services can be discontinued on an exchange area by exchange area basis, though this may require active measures to migrate residual customers. However, copper switch-off itself is not likely to happen during the lifetime of the CEI Decision or ANM Decision.

Identification of common costs

Despite these fundamental changes not being on the immediate horizon, care needs to be taken to identify common costs appropriately in the context of a future major change in Eir's activities due to the NBP. In particular, some costs that might have previously been considered fixed and common in the context of established patterns of operating an established copper network may in fact be incremental when considering migration from copper to fibre and progressive replacement by a fibre network within the IA. We understand that ComReg has erred on the side of caution in this regard, by prospectively reclassifying some previous common costs as incremental to the copper network.

This reclassification reduces the scale of the issue of common cost recovery, but also tends to increase incremental costs within the IA. Reclassifying costs as incremental only underscores the case that IA is not viable on a standalone basis and should not be making a contribution to Eir's remaining common costs.

2 Existing approach and respondents' comments

We first briefly set out ComReg's historic approach to date to the recovery of common costs.

2.1 Previous relevant ComReg decisions

D03/16

ComReg first set in place its current approach to recovery of common costs on copper services in D03/16, applying an equi-proportional mark-up (EPMU) to each service supplied by Eir's copper network. D03/16 also required nationally averaged prices in regard of wholesale services such as WLR. Subsequently, this situation was maintained in regard of WLA/WCA services by D10/18 and by D05/15 in regard of WLR pricing.

D11/18

D11/18 introduced the notion of differential recovery of common costs across geographical areas (as it was already clear at that time that Eir would not be offering future FTTH services nationally). Therefore, the issue of differential recovery of common costs across geographic areas was exposed for the first time, in contrast to previous pricing decisions where national averaging could be assumed.

Prices for FTTC/EVDSL, VUA and associated bitstream services used a modified approach, where common costs were recovered only in geographical areas deemed economic to serve – so-called "commercial lines" – rather than nationally. Within the commercial area, loops are shorter, and customers more densely located, than the national average. This leads to a lower average cost of copper-based services (including FTTC) within this area.

D11/18 considered that these commercial lines included cases where Eircom offer a commercial NGA service using either VDSL or FTTH in the Rural 300k network. Therefore, the Commercial Area in the context of the NBP intervention (i.e. the complement of the NBP Intervention Area) broadly corresponds to the concept of "commercial lines" within D11/18. The CA includes areas where competition is viable and there are competing infrastructures, but also includes areas where Eir's services are viable without subsidy (or cross-subsidy) but there are no current competitors and future competitors are unlikely.

D11/18 also set out ComReg's position that future wholesale services in the IA (including anticipated CEI access by NBI, even though most wholesale services were WLR at that time) would not need to contribute to common costs. This was largely due to the incremental costs of the copper network being higher within the IA, with the result that Eir could be assumed to be receiving little or no current contribution to common costs from services supplied in the IA.

In summary, though not a central concern at that time, in D11/18 ComReg already recognised the potential for some services to have limited ability to contribute to common cost recovery. The Decision set out the basic principle that whether services instrumental in replacing Eir's copper services in the IA (in particular CEI access) should make a contribution to common costs depends on whether the copper services being replaced are themselves making a common cost contribution.

3 Assessing common costs

When defining and measuring common costs, we need to consider that Eir's operations may change significantly if its copper network is switched off at some point in the future. Within the IA, this occurs progressively as NBI rolls out its fibre network and Eir becomes a purchaser of wholesale services from NBI. Copper switch off will also occur within the Commercial Area as commercial fibre services are rolled out.

Respondents to the ANM consultation questioned the definition and identification of Eir's common costs in a situation in which there are radical changes in Eir's operations due to the NBP.

There is a hierarchy of common costs depending on the breadth of services that are common. For example:

- Corporate overheads are common across all services (and so incremental to none in particular);
- Some costs may be common to all services derived from a given network infrastructure (e.g. common across all services running on a copper network, including wholesale services and access services);
- Some costs may be common across smaller groups of services.

Therefore, whether we consider a particular cost as common or incremental depends on the range of services that are hypothetically ceased when defining incremental cost (the "increment"). If we broaden the range of services that might hypothetically cease, we may reclassify a cost as incremental that had previously appeared common.

The ANM Draft Decision already sought to identify any costs that are incremental to the copper network taken as a whole. However, we should also acknowledge that, to date, there has been no need for ComReg to consider any significant variation in the footprint of Eir's copper network. As NBI replaces Eir within the IA as the network operator, Eir's role is reduced to a supplier of CEI. This raises the question of whether some costs that have previously been considered common (either as common corporate overheads or common across the copper network) might in fact be incremental when Eir's copper network footprint is reduced, by excluding the IA.

We understand that ComReg has identified some costs that have historically been considered as common as potentially being avoidable if Eir's copper network footprint is reduced. For example, one material issue is the treatment of rates as an overhead. These may be reduced[1] if Eir can eliminate redundant network assets from the IA, but they would have previously been considered common across copper services.

Eir exiting as a network operator within the IA is likely to lead to changes in its internal business processes. For example, procedures for fault identification and rectification may be quite different if NBI is the main user of poles and there is no need to maintain copper cables. Clearly it is difficult to anticipate what these changes might be before the event, as the change is largely unprecedented.

Given this difficulty, it might be reasonable for ComReg to treat some proportion of Eir's currently assessed common costs as prospectively incremental if its copper network in the IA were removed. A rough guide is provided by the proportion of lines with the IA (within the national total), which is a reasonable upper bound on the proportion of common costs that could be so misidentified; in practice, we would expect any such misidentification to be much less than this.

Treating some current common costs as being incremental to providing the copper network within the IA would have two immediate implications:

- The overall amount of common cost to be recovered across services, including both WLR and CEI, is reduced;
- Incremental costs within the IA are raised, which in turn has implications for assessment of the standalone viability of service within the IA.

Therefore, the rest of this note considers approaches to the recovery of the *remaining* common costs after such a reclassification has been made.

4 Recovery of common costs

A number of respondents raised concerns in the ANM and CEI consultations about the impact on the pricing of wholesale services in the CA if common costs are not recovered from the IA, with a different approach being taken relative to Generic Access to CEI (i.e. not the for purposes of supporting the NBP). There was concern

[1] The rateable value is based on the profitability of those assets, which could in principle increase for assets that are retained if loss making copper services in the IA are replaced by supplying CEI to NBI.

about the potential that services within the CA, which includes various access and wholesale services purchased by other providers from Eir, could include an element of cross-subsidy of services within the IA, because the IA was not contributing to recovery of common costs. Therefore, it is implicit to this view that Eir's services in the IA, which in future will become limited to CEI access as Eir is replaced by NBI, should contribute to Eir's common costs.

As set out in the introduction, we consider that these claims of cross-subsidy are misplaced, as they appear to deny the possibility that common costs could be differentially recovered from different services and geographies. This may be necessary if some services or geographies have limited (or indeed no) ability to make such a common cost contribution.

4.1 Ability to make common cost contributions

Whilst it is a broad principle of regulatory design that common costs should be recovered as widely as possible across various services, in order to reduce the distortive effect of raising price above incremental cost for any particular service, equally this principle implies that services should make contributions in line with their ability to do so. This principle is clear from the economic model of Ramsey pricing, where the contributions that services make to common cost recovery should reflect their relative ability to sustain a price increase above incremental cost without significantly supressing demand.

Often regulators lack information to tailor common cost contributions from different services to promote overall economic efficiency. In this case, it is common to use a proxy approach that splits common costs in line with the incremental costs of different services (so-called equi-proportionate markups or EPMU). However, where we have good reasons of principle indicating that certain services differ in their ability to contribute to common costs, other approaches may be justified. In particular, D11/18 differentiates services as being 'commercial' or 'non-commercial', with only the former making a contribution to common costs.

The question of whether services in the IA can contribute to common costs is an empirical one. However, as we set out in more detail in the sections below, there are good reasons to believe this not to be the case:

- Historically, ComReg has been of the view that copper services within the IA are not viable on a standalone basis and there is no evidence to doubt this conclusion;
- Reclassifying some costs previously treated as common as avoidable if Eir switches off its copper network in the IA leads to higher incremental costs (notwithstanding other

adjustments that ComReg has made to its cost modelling), reinforcing the preceding observation;

- The NBP has been specifically designed to reflect future fibre services within the IA being unviable without subsidy, and a State Aid case has made and cleared on this basis.

4.2 Implications of IA services contributing to common costs

In DotEcon's report on CEI access pricing[2], we raised the concern that recovering some part of Eir's common costs from the IA (when previously services in the IA have not been contributing) could lead to lower prices for Eir's wholesale services (of various types) within the CA. In turn, this could undermine incentives for competitive provision within the CA.

Historically, Eir is very likely to have been receiving little or no contribution to common costs from services supplied within the IA. Unfortunately, establishing the exact quantum is difficult, as ComReg's cost modelling did not previously separate these two geographical areas. Nevertheless, if Eir now started earning a material contribution to common costs from CEI access in the IA (or indeed on the supply of CEI to NBI within the CA), this would need services in the CA to make a smaller contribution than they otherwise would if Eir is not to over-recover its common costs.

If services supplied within the CA recovered a smaller part of common overhead costs, then we can expect a mix of competition and regulation to erode any temporary excess returns that Eir might earn from those services, leading eventually to prices for services being supplied within the CA being lower than they otherwise would have been. How exactly these price impacts might be spread across various services is difficult to forecast, but there is the potential to affect the incentives for competitive suppliers when deciding which activities within their value chain to purchase from Eir and which to self-supply. For instance, if generic CEI access within the CA is cheaper (than it otherwise would have been), then at the margin this discourages full infrastructure competitors; this is only relevant in limited locations within the CA where such competition is feasible, but clearly these possibilities cannot be ruled out. More generally, Eir's wholesale services used by competitors as inputs into their own services may become cheaper (than they otherwise would have been), which may discourage self-supply. To the extent that Eir has discretion, it may choose to focus these price reductions where it has greatest effect on competitors; these reductions would have enabled by additional margins earned by Eir on the supply of CEI to NBI, so

[2] https://www.comreg.ie/publication/dot-econ-report-annex-2-of-comreg-document-20-81

would have arisen specifically because of the NBP intervention and would be indirectly funded by subsidy.

The magnitude of any such pricing effects is limited by the much larger size of the CA relative to the IA. Nevertheless, there could be some adverse effect at the margin on choices of competitive operators. Given this potential downside, and the lack of any obvious upside, we have previously recommended that ComReg do not seek to recover a contribution to common costs within the IA.[3] This logic still applies and we do not see any countervailing reasons that would suggest that taking such a risk of competitive distortions might be justifiable.

Furthermore, from the perspective of competitive operators, we note that there should be a clear preference for Eir's common costs to be recovered to the greatest extent possible from the IA. Such an approach would tend to reduce prices for wholesale services bought (or potentially bought) by those operators within the CA relative to the counterfactual (though this may take time to play out as wholesale prices of various services are subject to regulatory review). The burden of paying for Eir's common costs shifts to NBI through the services NBI buys – primarily CEI access – within the IA. Some of these costs may end up covered by subsidy given to NBI. Therefore, even in the case that competitive operators buy wholesale services from NBI within the IA, they are certainly no worse off if Eir's common costs are differentially recovered from the IA, and likely better off if this leads to some of those costs not being passed though fully by NBI but in part covered by NBI's subsidises. Consultees' comments need to be viewed in the light of these incentives.

5 Cost estimates and historical viability of the IA

Historically, ComReg's cost modelling has indicated that copper services in the IA would likely not be economic on a standalone basis given nationally uniform wholesale pricing and, by implication are supported by implicit cross-subsidy from lower cost areas.

ComReg has recently updated its cost models and, in particular, Eir's WACC is now lower. This reduces incremental cost estimates. However, identifying some costs that were previously common as being incremental to providing copper services within the IA then tends to raise these incremental costs. Clearly there are significant uncertainties in these cost measurements, but we understand from ComReg that the net effect of making these changes to its cost

[3] See DotEcon's report forming Annex 2 to ComReg 20/81 (Draft Decision and Consultation on CEI access pricing).

models is to leave incremental cost estimates for the IA no lower than previous estimates; these revisions indicate a draft price for current generation standalone broadband of around €25 (as compared with a current average price of €22.80).

Therefore, we still have little evidence here to overturn ComReg's historic view that copper services within the IA have no ability to contribute to Eir's common costs if prices are geographical averaged. However, for completeness, we should also consider the question of whether there is any *potential* for copper-based services within the IA to contribute to Eir's common costs if prices were de-averaged, which we consider below.

6 National de-averaging of wholesale prices

Wholesale pricing

There is established competition in certain areas within the CA and ComReg has already de-regulated the Urban WCA/ Broadband Market. If any requirement (whether explicit or otherwise) for national **wholesale** pricing for copper services were removed, this should allow prices to be determined by competition within some areas of the CA (and potentially to fall). However, this also means that any ability Eir might have to cross-subsidise copper services in areas such as the IA, where incremental costs are expected to be higher than national average, would also be curtailed.

However, at the same time, moving away from national pricing gives the potential for wholesale prices for copper services in the IA to increase even within the broad requirement of prices being cost reflective, as cost measurement would be de-averaged too. Under national pricing, wholesale prices in the IA are constrained indirectly by competition in other areas, but this constraint falls away without national pricing.

Retail pricing

Eir's retail pricing is still required to be nationally averaged. ComReg is currently running a USO consultation that maintains a requirement for geographically average prices for retail voice services.[4]

Given this requirement on Eir, other retailers cannot simply raise their retail prices for services in the IA. Therefore, if wholesale prices

[4] See the consultation ComReg 21/51 on access at a fixed location, especially §243-259. ComReg has reached a preliminary conclusion at §259 that "...*geographical average should be retained to ensure that the standalone fixed voice cohort of customers are protected from price increases where they may have limited choice of service providers and who have not yet chosen to migrate to a bundle. These customers are unlikely to have an alternative to easily switch to should eir increase the retail line rental price or fixed telephony prices in general*." ComReg has issued in AFL USO interim designation decisions until 30/10/21 (ComReg D05/21) in response to this consultation.

for copper services are de-averaged, retail margins within the IA would be much reduced (or even negative) and retailers other than Eir would have little or no incentive to supply such customers.

Whilst we understand from ComReg that retail costs are approximately [✂[redacted] ✂]% of the overall cost stack, equally retail margins can be expected to be thin and, given this assumption, there will be limited ability to absorb these changes in wholesale prices without causing knock-on retail price effects. As retailing is a largely contestable activity, it would be unsafe to assume that a materially higher wholesale price could simply be mopped up in lower retail margin. Indeed, if Eir were to increase its wholesale price for copper services in this manner, then concerns about margin squeeze for alternative retailers could arise.

In our view, there is little *potential* for higher prices in the IA for copper services to be used to recover a common cost contribution for Eir. Given the clear policy objective to maintain nationally average retail prices, this sets a limit on the corresponding wholesale price for copper services within the IA that could potentially be charged without collapsing retailers' selling incentives.

In the current context, retail customers in the IA are not price sensitive. Indeed, they are likely to have few alternatives and would have to continue taking services even at much higher prices. For this reason, they are protected by price regulation given lack of network-level competition. Therefore, the unacceptably of raising prices for these customers is an expression of a policy choice. Whilst it would be quite possible for customers in the IA to pay considerably more, due to their current lack of a competitive alternative, and so make a contribution to Eir's common costs, this is ruled out by ComReg's policy preference for geographically averaged *retail* prices and the higher costs of serving these customers.

7 Implications and conclusions

The implications for CEI access pricing are clear. There are two logically coherent possibilities according to whether common cost contributions could be made by copper services in IA, absent the entry of NBI.

- First, if copper services in the IA are not able to cover their incremental costs, there is no loss of Eir's ability to recover common overhead costs caused by NBI's presence as Eir never had that ability. Therefore, we should not apply a mark-up for common cost to CEI access for NBP purposes in either the IA or CA.
- Second, if copper services in the IA are able to cover their incremental costs, then Eir will lose this ability to recover common cost (even if that ability might not currently be

being fully exercised due to national pricing). That may in turn require Eir being allowed to recover common costs elsewhere.

Summarising the preceding discussion, the available evidence strongly suggests that we are in the first case, with Eir not currently earning a margin over incremental cost within the IA on copper services. Reclassifying some costs that were previous common as incremental to Eir's copper network in the IA reinforces that conclusion. Given this, no markup for remaining common costs (after reclassification) is indicated for CEI.

Furthermore, even if we were in the second case, and Eir lost common cost contributions as copper services in the IA ceased, we would in any case need to consider what alternative source of common cost contributions would be most appropriate. This *might* be a markup on CEI access in the IA, which would have the advantage of progressively replacing lost common cost contributions as NBP rolled out, but this is not the only possibility. Given that fibre services within the IA would not be viable on standalone basis (and so need State Aid) is far from clear that even CEI access within the IA (as opposed to services downstream of it) would be standalone viable, given that NBI will become its predominant user. This would suggest looking to other services with greater ability to contribute to Eir's common costs instead.

As set out in our first report of CEI access pricing[5], there would be risk of competitive distortion within the CA from applying a mark-up for common costs on CEI in the IA:

- First, this would be a new and additional source of profitability for Eir in the short term until the prices of other services adjust (whether due to regulation, or competition) to make correspondingly smaller contributions to common costs. This additional profit would derive from Eir's uncontestable position as supplier of CEI in the IA.
- Second, wholesale and access services being somewhat cheaper in the CA (as their contribution to Eir's common costs would be reduced) risks, to some limited degree and over the longer term, reducing incentives for competitive providers.

For WLR, we have the additional issue that whilst a requirement for national retail prices is maintained on Eir, this greatly limits any scope for de-averaging the price of wholesale copper services between the IA and CA, as otherwise incentives to retail in the IA are undermined. Indeed, retailing copper services in the IA might even be unviable without cross-subsidy from retailing in the CA, which

5 https://www.comreg.ie/publication/dot-econ-report-annex-2-of-comreg-document-20-81

may limit competition at the retail level to larger retailers such as Eir able to sustain such cross-subsidies. This reinforces the case for CEI access in the IA making no contribution to common costs, as copper services in the IA have not, nor could under the current requirements for retail pricing, make such a contribution.