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# Oxera unfair burden report 2010/11

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Final report

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## Contents

<b>Executive summary</b>	<b>1</b>
<b>1 Introduction</b>	<b>4</b>
<b>2 Approach to determination of an unfair burden</b>	<b>5</b>
2.1 Overview of legal principles and methodologies	5
2.2 ComReg's approach to determining an unfair burden	5
<b>3 Administrative cost assessment</b>	<b>7</b>
<b>4 Assessment of eir's financial position</b>	<b>9</b>
4.1 Analysis of eir's profitability	10
4.2 Additional indicators of eir's financial position	15
4.3 Indicators of eir's economic situation	16
4.4 Summary	18
<b>5 Conclusions—is the net cost of the USO in 2010/11 an unfair burden?</b>	<b>20</b>
<b>A1 The scope of the relevant business</b>	<b>24</b>
A1.1 Options for the scope of the relevant business	24
A1.2 Why the fixed-line business has been chosen for Oxera's analysis	25

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## Boxes, figures and tables

Table 1.1	Quantitative indicators to assess unfair burden	2
Box 2.1	D04/11 principles and methodologies to determine unfair burden	6
Table 4.1	Quantitative indicators to assess unfair burden	10
Box 4.1	Relevant indicators of USP's profitability	11
Figure 4.1	eir's fixed-line business ROCE benchmarked against the WACC	13
Figure 4.2	eir's fixed-line business ROCE including and excluding the net cost of the USO	14
Figure 4.3	Cross-subsidisation (internalisation) of the net cost of the USO	15
Box 4.2	Additional indicators of USP's financial position	15
Table 4.2	Additional indicators of USP's financial position	16
Box 4.3	Relevant indicators of eir's economic situation	17
Figure 4.4	Changes in eir's fixed-line market share by revenue	17
Figure 4.5	Revenue yield movements for eir over time	18
Figure 4.6	Changes in eir customer numbers	18
Table 5.1	Unfair burden analysis summary 2010/11	21
Table A1.1	ROCE for the core USO business, fixed-line business and group-level business	25

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## Executive summary

In July 2016, eir<sup>1</sup> as a universal service provider (USP) in Ireland, submitted to the Commission for Communications Regulation (ComReg) a revised application for funding for the net cost of meeting the universal service obligation (USO) in its 2010/11 financial year. eir had revised its original application pursuant to a period of engagement with ComReg. To inform its assessment of this application, ComReg has asked Oxera to assess whether financing the USO represented an unfair burden on eir in its financial year 2010/11.

ComReg Decision D04/11<sup>2</sup> (D04/11) sets out the principles and methodologies that underpin unfair burden assessment in USO funding applications. In accordance with Irish and European legislation,<sup>3</sup> in order for the USP to receive compensation for any net cost, it is necessary to first determine that it represents an unfair burden.

This report assesses the application for USO funding by reference to the principles and methodologies set out in D04/11, and its purpose is to inform ComReg's determination as to whether the net cost of the USO represented an unfair burden on eir in the year of application.

D04/11 set out three cumulative conditions that must be met for there to be an unfair burden (Decision 38):

1. There must be a verifiable and verified direct net cost
2. The benefits of the USO must not outweigh the net cost (i.e. there is a positive net cost)
3. This positive net cost is (a) material compared to administrative costs of a sharing mechanism, and (b) causes a significant competitive disadvantage for a USP.<sup>4</sup>

eir's 2010/11 application identified a net cost of €7.9m.<sup>5</sup> Decisions 39 to 42 of D04/11 set out further detail on the assessment to be carried out by ComReg, as discussed in section 2.2 of this report. In this report, we consider the size of the net cost relative to the costs of a sharing mechanism and we assess the USP's financial position. In summary, we have carried out the following assessments.

- **Administrative cost assessment (Decision 39)**—Oxera has found that the net cost of the USO is not small relative to the administrative costs of establishing and operating a sharing mechanism.
- **Assessment of the USP's financial position in 2010/11 (Decision 40)**—having assessed that the net cost of the USO is not small relative to the administrative costs of a sharing mechanism (Decision 39), and having regard to the criteria outlined in Decision 42, Oxera has analysed the USP's financial position in 2010/11. Oxera has assessed the absolute level of eir's profitability as well as its return on capital employed.

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<sup>1</sup> Eircom Limited, known as Eircom until September 2015.

<sup>2</sup> ComReg (2011), 'Decision on the costing of universal service obligations: Principles and Methodologies', 11/42, 31 May (D04/11).

<sup>3</sup> As described in greater detail in section 2.

<sup>4</sup> We refer to the 'positive net cost' as 'net cost' in this report.

<sup>5</sup> Oxera has been instructed by ComReg to base its analysis on the net cost figure derived from eir's revised application submitted in July 2016. To the extent that the net cost estimate submitted by eir may be revised downward by ComReg by excluding certain costs, Oxera is advised that €7.9m represents an upper bound for the figure that will be allowed for the current application period.

- Oxera has also considered additional financial indicators, and as broader context for the profitability analysis, indicators of eir's economic situation such as its pricing and fixed line market share, which illustrate the context of the fixed line market in which eir operates. We found that the USP's profitability and ability to earn a fair rate of return on its capital employed, has not been significantly affected by the net cost of the USO. The analysis of the USP's financial position shows that the net cost of the USO did not constitute an unfair burden in 2010/11.

Oxera's findings in relation to quantitative indicators used to assess whether there is an unfair burden, are summarised in Table 1.1 below.

**Table 1.1 Quantitative indicators to assess unfair burden**

	2010/11	Relevant section
USO net cost	€7.9m	Section 3
Administrative costs <sup>1</sup>	€0.4m	Section 3
Earnings before interest and taxes (EBIT)	€388m	Section 4.1
Return on capital employed (ROCE)	26.1%	Section 4.1
Increase in ROCE, if there were no USO net cost	0.53%	Section 4.1
WACC range (point estimate)	7.77–11.08% (10.21%)	Section 4.1
USO net cost as a proportion of revenue	0.62%	Section 4.2
USO net cost as a proportion of EBIT	2.0%	Section 4.2
Market share by revenue <sup>2</sup>	62%	Section 4.3
Annual change in total ARPU	[><]	Section 4.3
Annual change in total customers	[><]	Section 4.3

Note: <sup>1</sup> We have not estimated a new figure of administrative costs for this application; rather, we have used the figure which applied in the assessment of the 2009/10 funding application. The extent of the differential between the current net cost of the USO (i.e. €7.9m) and the previous estimate of administrative costs of €0.4m is significant enough to suggest that an increase in administrative costs (e.g. due to inflation) since 2009/10 would not have eliminated this differential. <sup>2</sup> The market share by revenue is based on total external revenues from fixed-line services.

Source: Oxera analysis.

Given the USP's financial position in 2010/11, Oxera is of the view that the net cost did not significantly affect eir's profitability, and its ability to earn a fair rate of return on its capital employed. Oxera has not therefore applied Decision 41 (i.e. whether the net cost materially impacts eir's ability to compete on equal terms with competitors going forward).

In summary, eir's financial position indicates that, in the period under assessment, the net cost of the provision of the USO did not impose an unfair burden. During the financial year 2010/11, eir provided the USO while earning profits that were in excess of the regulatory allowed weighted average cost of capital (WACC), referred to as the 'competitive benchmark'.<sup>6</sup> Notwithstanding a decline in its total number of customers, eir's average revenue per user was stable in 2010/11 relative to the 2009/10 financial year and it retained a majority market share by revenue in the fixed-line market, and it was well positioned to internalise the cross-subsidy in providing the USO.

<sup>6</sup>WACC is a benchmark measure of the return that investors (i.e. equity owners and lenders) can expect from investing in a business. See section 4 for further discussion.

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The net cost of the provision of the USO did not, in Oxera's view, represent an unfair burden on eir in the financial year 2010/11.

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## 1 Introduction

In D04/11 ComReg sets out the principles and methodologies for assessing whether the USO results in a net cost that represents an unfair burden on the USP.<sup>7</sup> European and Irish legislation<sup>8</sup> provide that, in order for the USP to receive compensation for any net cost, it is necessary to determine that there is an unfair burden. This is reflected in D04/11.

eir's universal service obligations during the relevant period included the following:<sup>9</sup>

- provision of access at a fixed location;
- provision of a printed telephone directory and the maintenance of the National Directory Database (NDD);
- provision of public pay phones;
- provision of services to consumers with disabilities;
- provision of measures to assist consumers to control their expenditure.

In July 2016, eir submitted its revised application for funding for 2010/11.<sup>10</sup> In summary, eir's revised estimates showed a total direct net cost of the USO of €9.5m, which, when offset by €1.6m of intangible benefits, results in an estimated net cost of €7.9m.<sup>11</sup>

This report applies the principles and methodologies set out in D04/11 to assess whether the net cost of the provision of the USO represented an unfair burden on eir in 2010/11. Oxera's analysis informs ComReg's determination on whether there is an unfair burden in 2010/11. The report is structured as follows.

- Section 2 summarises the approach taken by Oxera to assess whether the net costs represents an unfair burden.
- Section 3 presents analysis of the level of the net cost, consistent with Decision 39.
- Section 4 presents analysis of the USP's financial position including the impact of the net cost on profitability, consistent with Decision 40, and sets out Oxera's view on whether the net cost for this application represents an unfair burden.
- Section 5 sets out our conclusion to inform ComReg's determination.

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<sup>7</sup> ComReg (2011), op. cit.

<sup>8</sup> European Communities (Electronic Communications)(Universal Service and Users' Rights) Regulations 2003.

<sup>9</sup> Information received from ComReg.

<sup>10</sup> eir's initial application for USO funding was submitted in September 2014. The net cost estimates were revised in July 2016, following the discussions between ComReg and eir.

<sup>11</sup> Oxera has been instructed by ComReg to base its analysis on the net cost figure derived from eir's revised application submitted in July 2016. To the extent that the net cost estimate submitted by eir may be revised downward by ComReg by excluding certain costs, Oxera is advised that €7.9m represents an upper bound for the figure that will be allowed for the current application period.

## 2 Approach to determination of an unfair burden

This section sets out the relevant decisions in D04/11, which are to be applied to the determination of whether there is an unfair burden on a USP.

### 2.1 Overview of legal principles and methodologies

The Universal Service Directive 2002/22/EC (the 'Directive') provides that, even if there is a verifiable net cost for the USP it is necessary to establish that the cost represents an unfair burden on the USP, if the financing of the USO is to be compensated.<sup>12</sup> EU case law confirms that the Directive gives ComReg (and other NRAs) discretion in determining what constitutes an unfair burden.<sup>13</sup>

This requirement has been transposed into Irish legislation by Regulation 12 of the European Communities (Electronic Communications Networks and Services) (Universal Service and Users' Rights) Regulations 2011 (the 'Regulations'). This requires that, where found, an unfair burden is addressed by establishing a sharing mechanism, with other operators contributing to the cost of the universal service.

D04/11 sets out principles and methodologies for ComReg to apply in determining whether any net cost represents an unfair burden, and, as a direct consequence, in accordance with the Regulations, whether a sharing mechanism should be implemented.

We are advised by ComReg that the *Base case*<sup>14</sup> is relevant to the assessment of whether there is an unfair burden. We are further advised that D04/11, and in particular Decisions 38–42, apply the *Base case* by taking into account eir's own characteristics and its ability to bear the net cost. According to the *Base case*, a national regulatory authority must consider whether the burden on a USP is:

...excessive in view of the undertaking's ability to bear it, account being taken of all the undertaking's own characteristics, in particular the quality of its equipment, its economic and financial situation and its market share.<sup>15</sup>

In this report Oxera applies D04/11 to assess whether the net cost represents an unfair burden on eir.

### 2.2 ComReg's approach to determining an unfair burden

D04/11 determined three cumulative conditions that must be met in order to establish an unfair burden (Decision 38):

- there must be a verifiable and verified direct net cost;
- the benefits of the USO must not outweigh the net cost (i.e. there is a positive net cost);
- this positive net cost is (a) material compared to administrative costs of a sharing mechanism, and (b) causes a significant competitive disadvantage for a USP.

<sup>12</sup> Directive 2002/22/EC of the European Parliament and of the Council of 7 March 2002 on universal service and users' rights relating to electronic communications networks and services (Universal Service Directive), OJ L 108/51, 24.4.2002.

<sup>13</sup> *Commission v Belgium*, Case C-222/08, paragraph 44, 45 and 50; *Base NV and Others vs Ministerraad*, Case C-389/08, Judgment of the Court (Fourth Chamber), 6 October 2010, paragraph 43.

<sup>14</sup> *Base NV and Others vs Ministerraad*, Case C-389/08, Judgment of the Court (Fourth Chamber), 6 October 2010. Also included in ComReg (2011), op. cit., pp. 63–64.

<sup>15</sup> *Base NV and Others vs Ministerraad*, op. cit., para. 42.



As noted above, in D04/11 ComReg sets out the principles and methodologies to be applied in determining whether a net cost of the USO represents an unfair burden. This is summarised in Box 2.1.

**Box 2.1 D04/11 principles and methodologies to determine unfair burden**

- **Administrative cost assessment (Decision 39)**—if the positive net cost is relatively small, ComReg will determine, on the basis of audited costs of the USO, whether USO financing is or is not justified, taking into account the administrative costs of establishing and operating a sharing mechanism (compared to the positive net cost of the USO) and taking into account whether these costs are disproportionate to any net transfers to a USP.
- **Assessment of the USP's financial position (Decision 40)**—if the positive net cost is not relatively small, ComReg will assess whether or not this net cost significantly affects a USP's profitability and/or ability to earn a fair rate of return on its capital employed.
- **Competitive distortions assessment (Decision 41)**—if the positive net cost significantly affects a USP's profitability, ComReg will assess whether or not such a net cost materially impacts a USP's ability to compete on equal terms with competitors going forward.
- **Supporting criteria to determine unfair burden (Decision 42)**—outlines criteria that will be used by ComReg 'statically and dynamically, to determine whether or not a net cost burden is actually unfair.'

These supporting criteria in Decision 42 are:

1. Changes in profitability, including an understanding of where a USP generates most of its profits over time.
2. Changes in accounting profits and related financial measures—e.g. earnings before interest, tax, depreciation and amortisation (EBITDA) analysis.
3. Changes in direct USO net cost, if any, over time.
4. Estimates of average level of cross-subsidy between classes of more or less separately accounted for services, and changes in these over time.
5. Changes in prices over time.
6. Changes in market share and/or changes in related markets.
7. Market entry barriers.

Source: ComReg (2011), 'Decision on the costing of universal service obligations: Principles and Methodologies', 11/42, 31 May (D04/11), pp. 86–87.

### 3 Administrative cost assessment

This section considers the size of the net cost in eir's application and whether the net cost is relatively small compared with the administrative costs of establishing and operating a sharing mechanism, taking into account the net transfers to a USP. Oxera's evaluation applies the following decisions within D04/11.

- **Decision 38 (3)**—'This positive net cost is [...] material compared to the administrative costs of a sharing mechanism [...]'.<sup>16</sup>
- **Decision 39**—'If the positive net cost is relatively small, ComReg will determine, on the basis of audited costs of the USO, whether USO financing is or is not justified, taking into account the administrative costs of establishing and operating a sharing mechanism (compared to the positive net cost of the USO) and taking into account whether these costs are disproportionate to any net transfers to a USP.'<sup>17</sup>

The positive USO net cost estimate<sup>16</sup> in 2010/11, as per eir's application was €7.9m. This is the USO direct net cost less the intangible benefits associated with the USO, as claimed by eir in its 2010/11 application, submitted in July 2016.<sup>17</sup> Specifically, eir's estimates showed a total direct net cost of the USO of €9.5m which, when offset by €1.6m of intangible benefits, resulted in an estimated net cost of €7.9m.

eir's estimate of the net cost of the USO for 2010/11 is €7.9m, while Oxera's analysis as part of the 2009/10 application indicated that the administrative cost of a sharing mechanism was likely to be in the region of €0.4m.

We have not prepared a new estimate for administrative costs as part of the assessment of the current application. This is because the extent of the differential between the net cost (€7.9m) and the previous estimate for administrative cost (€0.4m) is significant enough to suggest that an increase in administrative costs (e.g. due to inflation) since the date of assessment of the 2009/10 application would not eliminate this differential. Therefore, in Oxera's view, the net cost of the USO in 2010/11 was not relatively small compared to the administrative costs of a sharing mechanism.

Decision 39 also provides that the cost of establishing and operating a sharing mechanism is to be compared with the potential net transfer to the USP, were a sharing mechanism to be established. In its 2009/10 Determination, ComReg assumed for illustrative purposes that if the sharing mechanism were established, eir would be likely to be compensated for approximately 70% of the net cost of the USO from other market participants, as a net transfer to the USP.<sup>18</sup> This assumption of 70% was based on eir's share of 'all Electronic Communication Revenues' at the time.<sup>19</sup> Even if eir's share were lower, at say 50%, the hypothetical 'net transfer' to the USP would be around €4m if such a sharing mechanism were to be established (i.e. illustratively, 50% of the net cost of €7.9m in 2010/11). It is therefore apparent that there is a significant differential

<sup>16</sup> We refer to the 'positive net cost' as 'net cost' in this report.

<sup>17</sup> ComReg's preliminary verification of the net cost will be included in the consultation document relating to the 2010/11 application, and may include adjustments to the net cost claimed by eir (based on advice from its consultants, TERA (which verified the direct net cost), as well as Oxera (as we analysed eir's calculation of intangible benefits in 2010/11, in a separate report).

<sup>18</sup> ComReg (2014), 'Assessment of Eircom's Universal Service Fund Application for 2009-2010– Response to Consultation and Determination', ComReg 14/03, Final and Non-Confidential, para. 9.16.

<sup>19</sup> Ibid.

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between a likely net transfer estimate to the USP, and the administrative costs estimate for establishing and operating such a sharing mechanism.

Therefore, we conclude that the net cost of the USO in 2010/11 was material compared to the administrative cost of a sharing mechanism. The net cost of the USO was also significantly higher than an estimate of the net transfer to the USP, were a sharing mechanism to be established.

As a result, it would be proportionate to establish a sharing mechanism if it was found that the provision of the USO in 2010/11 represented an unfair burden on the USP.

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## 4 Assessment of eir's financial position

D04/11 provides that ComReg will assess whether the net cost significantly affects a USP's profitability and/or ability to earn a fair rate of return on its capital employed, in the context of assessing whether the net cost of USO represents an unfair burden.

Consistent with D04/11 Decisions 40 and 42, this section undertakes an assessment of eir's financial position in the relevant period,<sup>20</sup> including the impact on eir's profitability and ability to earn a fair rate of return on capital employed. eir's profitability and ability to earn a fair rate of return on capital employed are measures of its financial position and can be used to assess its ability to bear the burden of the net cost.

The assessment of eir's financial position presented in this section considers the following criteria from Decision 42:

- **Decision 42 (2)—changes in accounting profits and related financial measures** (section 4.1.1). We look at the absolute level of eir's fixed-line business profitability on the basis of earnings before interest and taxes (EBIT). This aids understanding of the relevant measures of profitability listed below.
- **Decision 42 (1)—changes in profitability, including an understanding of where a USP generates most of its profits over time** (sections 4.1.2 and 4.2). We analyse eir's return on capital employed relative to a competitive benchmark, to establish the effect of the net cost on the USP's profitability and ability to earn a fair rate of return on its capital employed, as outlined in Decision 40. We also assess additional indicators of the USP's financial position.
- **Decision 42 (4)—the average level of cross-subsidy between classes of more or less separately accounted for services, and changes in these over time** (section 4.1.2). In this section we consider whether eir could internalise the net cost of the USO.
- **Decision 42 (5), 42 (6)—changes in prices over time, and changes in market share and/or changes in related markets** (section 4.3). In this section, we have considered economic indicators as broader context for the profitability analysis.

Before presenting the detailed financial analysis that has been undertaken in this section, the table below provides an overview of the assessment of eir's financial position in 2010/11, consistent with Decision 40 of D04/11.

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<sup>20</sup> Note, as context, that D04/11 has established that eir's level of indebtedness, which is not driven by the USO, is not a relevant factor to consider in this context (i.e. in analysis of the USP's financial position).

**Table 4.1 Quantitative indicators to assess unfair burden**

	<b>2010/11</b>	<b>Relevant section</b>
Earnings before interest and taxes (EBIT)	€388m	Section 4.1
Return on capital employed (ROCE)	26.1%	Section 4.1
Increase in ROCE, if there were no USO net cost	0.53%	Section 4.1
WACC range (point estimate)	7.77–11.08% (10.21%)	Section 4.1
USO net cost as a proportion of revenue	0.62%	Section 4.2
USO net cost as a proportion of EBIT	2.0%	Section 4.2
Market share by revenue <sup>1</sup>	62%	Section 4.3
Annual change in total ARPU	[>]	Section 4.3
Annual change in total customers	[>]	Section 4.3

Note: <sup>1</sup> The market share by revenue is based on total external revenues from fixed-line services.

Source: Oxera analysis.

Where possible, Oxera has examined changes in eir's profitability over time (i.e. in 2010/11 relative to the prior year performance in 2009/10). However, it has not been possible to carry out a like-for-like comparison of revenues and profitability in 2010/11 against those in 2009/10, due to changes in the format of the regulatory accounts. In particular, in the 2009/10 regulatory accounts eir's business was disaggregated into Businesses and Activities categories, while the HCA regulatory accounts for 2010/11 split eir's business into Market Groups and Markets categories.

Note also that in assessing eir's financial position, Oxera has focused on profitability and financial indicators for eir's fixed-line business.<sup>21</sup> In an earlier Oxera report, Oxera (2013b), we discussed that the integrated fixed-line business represented a good proxy for the profitability of the businesses that could be directly linked to the USO network.<sup>22</sup> We consider that the fixed-line business remains appropriate for undertaking the analysis of the USP's financial position. For more details, see Annex A1.

#### **4.1 Analysis of eir's profitability**

In this section we undertake financial analysis with a view to establishing the effect of the net cost on eir's profitability and its ability to earn a fair rate of return on its capital employed, as in Decision 40.

Analysis of eir's profitability is summarised in the box below.

<sup>21</sup> That is, all of eir's integrated fixed-line business, including wholesale and retail, and business and residential, including data communications and interconnection services. Mobile services are excluded from this business scope.

<sup>22</sup> See Oxera (2013b), 'Review of eircom's response to ComReg's consultation on the "Assessment of Eircom's Universal Service Fund Application for 2009-2010"', December, ComReg Document 14/03a.

## Box 4.1 Relevant indicators of USP's profitability

Decision 40 states that 'If the positive net cost is not relatively small, ComReg will assess whether or not this net cost significantly affects a USP's profitability and/or ability to earn a fair rate of return on its capital employed'.

- Accordingly, taking into account the criteria in Decision 42 (1), Oxera has examined the USP's profitability in 2010/11 as an estimated return on capital employed (ROCE) for eir in 2010/11 of 26.1%; which is compared to a competitive benchmark for eir's profitability, i.e. a WACC range (point estimate) of 7.77–11.08% (10.21%).

Decision 42 (2) states that one of the criteria used by ComReg 'to determine whether or not a net cost burden is actually unfair' will include 'Changes in accounting profits and related financial measures, e.g. earnings before interest, tax, depreciation and amortisation ("EBITDA") analysis.'

- Accordingly, Oxera has examined the absolute level of eir's accounting profits as measured by earnings before interest and tax (EBIT). In 2010/11, the relevant measure of eir's EBIT was €388m.

### 4.1.1 Absolute level of eir's profitability

In 2010/11, eir reported absolute profit (EBIT) of €388m in the fixed-line business, measured as revenues less operating costs.

Decision 42 (2) of D04/11 indicates that the criteria used by ComReg 'to determine whether or not a net cost burden is actually unfair' will include 'Changes in accounting profits and related financial measures'. One measure of accounting profits identified by ComReg is earnings before interest, taxes, depreciation and amortisation (EBITDA). Another financial measure which can be used in the analysis is EBIT—a related measure, net of depreciation and amortisation expense. Oxera's analysis of the USP's financial position focuses on EBIT, rather than EBITDA, as EBIT is a more commonly used measure of operating profit. Oxera has undertaken checks on the level of EBITDA profits, which show that the conclusions of the analysis of the USP's financial position in 2010/11 would not be affected by focusing on EBITDA as a measure of profit instead; EBITDA profits are higher than EBIT.

In terms of assessing changes in accounting profits or related financial measures, it has not been possible to carry out a like-for-like comparison of revenues and profitability in 2010/11 against those in 2009/10, due to changes in the format of the regulatory accounts, as outlined in section 4 above.

### 4.1.2 Profitability analysis based on ROCE

Oxera has undertaken analysis of eir's profitability in order to assess whether eir was able to earn a fair rate of return on its capital employed in 2010/11. Specifically, we have compared a return on capital employed (ROCE) measure of eir's financial returns to a competitive benchmark level of return on capital, as described by ComReg's estimate of eir's weighted average cost of capital (WACC).<sup>23</sup>

- **What is ROCE?** The ROCE is an accounting-based financial returns metric, which captures the relationship between operating profits and capital employed in a business. The ROCE measure is widely used to assess

<sup>23</sup> Other measures of profitability such as margins-based analysis, or internal rate of return (IRR) analysis, have not been analysed in this report. Since a measure of the asset base is readily available, it is preferable to undertake ROCE analysis rather than margins-based analysis, e.g. return on sales. The IRR has not been estimated as this measures economic returns over the lifecycle of an investment, while D04/11 requires instead an assessment of the USP's financial position within a particular period of time, i.e. the relevant annual application period.

profitability in market investigations and inquiries by the Competition and Markets Authority (CMA) in the UK, as well as by the European Commission.

Oxera's estimate of ROCE for eir is calculated as the ratio of eir's operating profits (measured by EBIT) and capital employed (based on HCA values of assets)<sup>24</sup> in its fixed-line business. Oxera can reliably estimate eir's ROCE since eir's level of operating profit and capital employed for its fixed-line business is detailed in its HCA regulatory accounts.

The ROCE can then be compared to a suitable competitive benchmark (see description of WACC below). A ROCE-based profitability analysis is consistent with the *Base case*<sup>25</sup> in that it takes into account eir's own characteristics by providing a measure of the financial performance of eir, which inherently takes into account eir's economic and financial situation.

- **What is WACC?** The weighted average cost of capital (WACC) is commonly used by regulators and authorities in competition cases as a benchmark measure of the return that investors (i.e. equity owners and lenders) can expect from investing in a business. WACC represents an investor's opportunity cost of assuming the risk of investing in a company or, in other words, the return that an investor would require as a benchmark for investing.

In price control decisions, regulators (including ComReg) typically use a WACC estimate in determining the allowed profit that investors can earn. In competition cases, authorities typically use a WACC estimate as a benchmark return in examining whether excess profits have been, or are being, earned.

For the relevant period, ComReg had decided that eir's regulatory allowed WACC was 10.21%, taken from a range of 7.77–11.08%.<sup>26, 27</sup> As this WACC was calculated specifically for eir, its use in analysing eir's profitability is consistent with the requirements of the *Base case*, as it reflects eir's individual characteristics.

In our view, a ROCE-based profitability analysis is a key indicator of eir's ability to earn a fair rate of return on its capital employed.

Figure 4.1 below sets out a comparison of eir's actual profitability (ROCE) against the competitive benchmark return (the WACC). This shows that in 2010/11, eir's fixed-line business ROCE exceeded the WACC by 15.9%.

To further contextualise eir's financial position, it is relevant to note that:

- the ROCE for the fixed-line business exceeded not only the point estimate of the allowed WACC, but also the upper end of the WACC range estimated by ComReg, by 15.1%;
- for there to be no returns above the WACC, the net cost of the USO would have to have been around 31 times higher; or, alternatively,
- the absolute profit (EBIT) for the fixed-line business would have to have been around 61% lower for the application period, 2010/11.

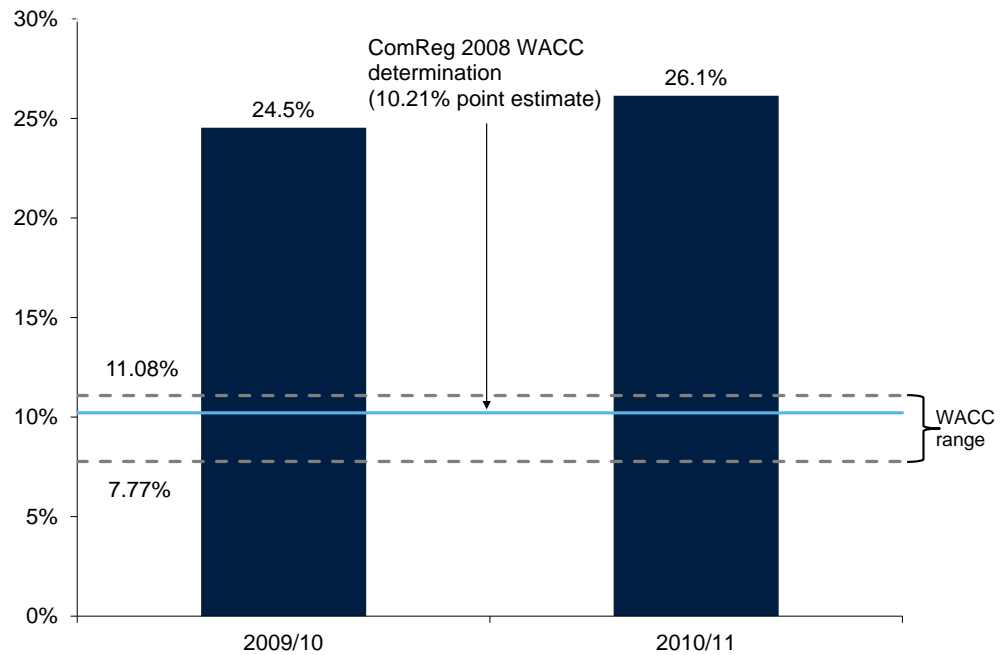
<sup>24</sup> These are values as reported by eir, in its historical cost regulatory separated accounts. Note that Decision 1 of D04/11 requires the use of the HCA methodology in calculating the net cost of the USO.

<sup>25</sup> *Base NV and Others vs Ministerraad*, op. cit.

<sup>26</sup> ComReg (2008), 'Eircom's Cost of Capital', May, ComReg Document 08/35.

<sup>27</sup> The use of a range in calculating a WACC is common practice.

**Figure 4.1 eir's fixed-line business ROCE benchmarked against the WACC**



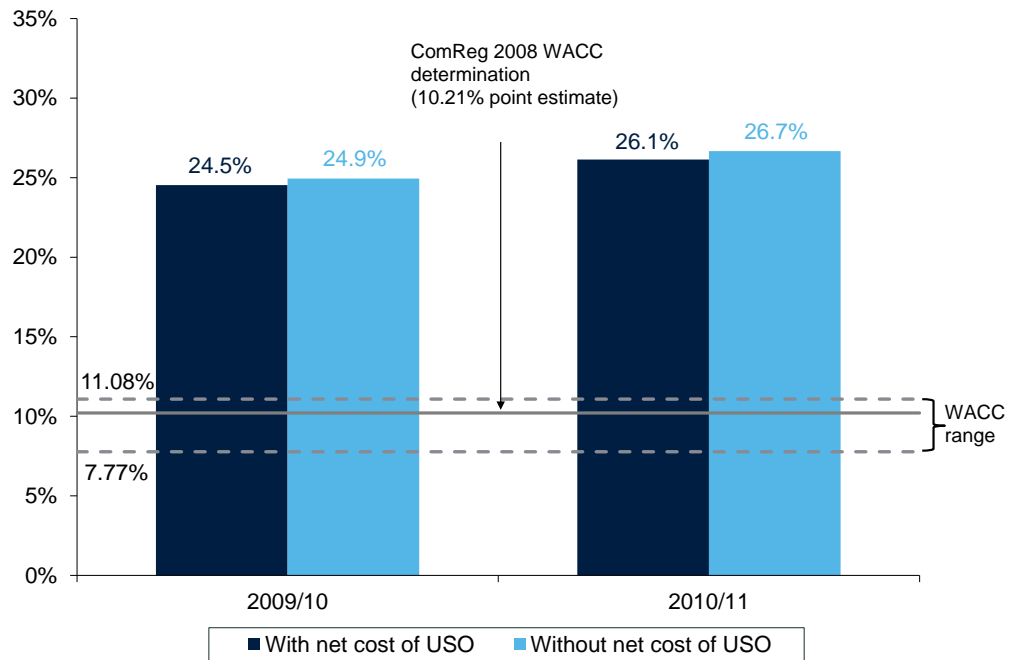
Note: Data was not available on a directly comparable basis for 2009/10 due to changes in the format of the regulatory accounts.

Source: Oxera analysis based on ComReg's 2008 WACC determinations and eir's historical cost regulatory separated accounts.

Figure 4.2 compares the effect of the net cost with respect to its impact on profitability (measured as a ROCE of the fixed-line business). The figure illustrates the impact of the net cost of the USO on the profitability of the fixed-line business. Specifically, it shows a counterfactual scenario, whereby if eir had not incurred the net cost of providing the USO, its ROCE would have been approximately 0.5% higher in 2010/11. (Note: equivalently, this 0.53% estimate can be interpreted as the net cost as a proportion of mean capital employed).



**Figure 4.2** eir’s fixed-line business ROCE including and excluding the net cost of the USO



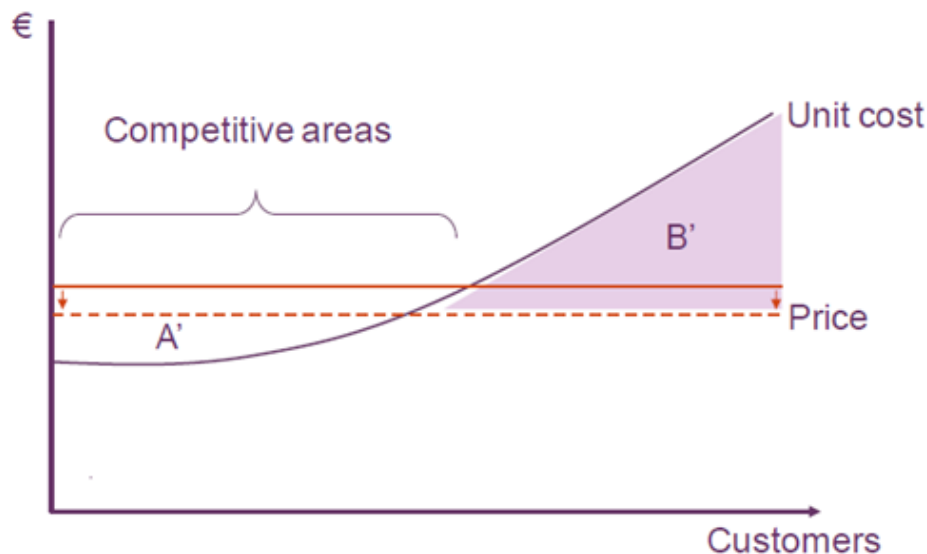
Source: Oxera analysis based on eir’s historical cost regulatory separated accounts and eir’s submissions to ComReg.

The ROCE is a measure of accounting profitability for a given period of time, typically annual. We have considered whether a temporary fluctuation in market conditions might have had an impact on eir’s ROCE for the fixed-line business in 2010/11, and caused eir’s ROCE for the fixed-line business in 2010/11 to exceed the WACC. As noted earlier, the data shows that for there to be no returns above the WACC in 2010/11, the net cost of the USO would have to have been around 31 times higher or, alternatively, the absolute profit (measured as EBIT) for the fixed-line business would have to have been 61% lower. Also, to the extent that any boost or reduction in eir’s profitability in a given year is attributable to temporary market fluctuations, this would be expected to reverse in future years, and this would be observed in the analysis of eir’s ROCE in subsequent application periods.

ComReg’s approach to the assessment of whether the net cost of the USO represents an unfair burden also considers, in line with the criteria in Decision 42 (4), whether eir, as the USP, is able to earn sufficient profits to finance its costs in uneconomic areas/customers from profits in economic areas/customers. This is referred to as a ‘cross-subsidy’ and is illustrated in D04/11 as shown in Figure 4.3 below.

From the perspective of the USP’s financial position, if the USP earns sufficient profits within the integrated fixed-line business to enable it to cross-subsidise the costs of providing the USO, then this indicates that it is able to bear the burden of the net cost of the USO.

**Figure 4.3 Cross-subsidisation (internalisation) of the net cost of the USO**



Source: ComReg (2011), op. cit., p. 66, Figure 2.

eir's returns were in excess of the competitive benchmark or a 'fair rate of return' as measured by the regulatory allowed WACC, including the upper end of the WACC range estimated by ComReg for the relevant period. Given the level of profits that were being earned by eir in the fixed-line business in 2010/11, we have not disaggregated the profitability of segments included within the fixed-line business (e.g. 'Retail Other'<sup>28</sup>) to assess in further detail divisional financial strength, and the extent to which each division is capable of cross-subsidising the net cost of the USO.

For the 2010/11 application period, eir was well positioned to internalise the net cost, or in other words, to cross-subsidise the provision of the USO by using profits that were earned in segments of the fixed-line business. In this context, eir has the ability to bear the burden of the net cost of the USO.

## 4.2 Additional indicators of eir's financial position

### Box 4.2 Additional indicators of USP's financial position

As part of the analysis of the USP's financial position per Decision 40, Oxera has also considered the impact of the USO by reference to additional financial indicators:

- an estimate of the USO net cost as a proportion of eir's revenue of 0.62%;
- an estimate of the USO net cost as a proportion of eir's EBIT of 2.0%.

As noted earlier, in our view, a ROCE-based profitability analysis is a key indicator of eir's ability to earn a fair rate of return on its capital employed. As part of the analysis of the USP's financial position per Decision 40, Oxera has also considered the impact of the USO by reference to additional financial indicators, i.e. net cost as a proportion of (i) revenues and (ii) EBIT.

Unlike the consensus among regulators and competition authorities as regards the appropriateness of using a measure of the WACC as a reasonable competitive benchmark for measuring whether profitability is excessive, there is

<sup>28</sup> The 'Retail Other' segment includes 'Retail Voice Calls', 'Retail DSL/Broadband' and 'Retail Residual' sub-segments.

no such consensus as regards the use of thresholds for the above financial indicators. We are also not aware of any prescriptive case law (or guidance in D04/11) which sets out which possible thresholds for the above financial indicators would suggest that the USP's financial position is significantly affected. Oxera's earlier report (2013a) had regard to what regulatory and accounting precedent existed. Based on the limited available precedent, Oxera (2013a) identified 0.5–1.0% of revenues, or, 5–10% of profitability (EBIT), as a reasonable benchmark for determining the effect of the size of the net cost on the USP's profitability.<sup>29</sup> While these financial indicators can be useful to consider, given that there do not appear to be clear definitive thresholds and that there is differing evidence for possible thresholds, one cannot use these indicators to determine with certainty whether a USP's financial position is significantly affected. Rather, these indicators show the scale of the net cost in the application period, with reference to the size and profits of the fixed-line business of the firm (i.e. as a ratio of its revenues and EBIT). By presenting the scale of the net cost, these indicators provide contextual information regarding the effect of the net cost on the USP's financial position.

The results of Oxera's calculations for net cost as a proportion of (i) revenues and (ii) EBIT are summarised in the table below. The analysis summarised in Table 4.2 does not change the outcome of the ROCE profitability analysis (as set out in section 4.1.2 above), that eir's profitability and ability to earn a fair rate of return on capital employed are not significantly affected by the net cost.

**Table 4.2 Additional indicators of USP's financial position**

	2010/11
Net cost as a proportion of revenues <sup>1</sup>	0.62%
Net cost as a proportion of EBIT	2.0%

Note: <sup>1</sup> The revenues are based on the sum of external revenues and internal revenues (inter) as per eir's regulatory accounts.

Source: Oxera analysis based on eir's historical cost regulatory separated accounts.

### 4.3 Indicators of eir's economic situation

In this section we have considered indicators of eir's economic situation, specifically eir's pricing and its fixed line market share, as broader context for the profitability analysis (as set out at section 4.1). These economic indicators illustrate the context of the fixed line market in which eir operates.

<sup>29</sup> Oxera (2013a), 'Does the universal service obligation represent an unfair burden for eircom?', February, ComReg Document 13/45c.

### Box 4.3 Relevant indicators of eir’s economic situation

Decisions 42 (5) and 42 (6) include an assessment of changes in prices over time and changes in market share.<sup>1</sup>

Accordingly, in this section, Oxera has examined evidence on prices (measured as average revenue yield per user, or ‘ARPU’) and has also examined evidence on eir’s market share.

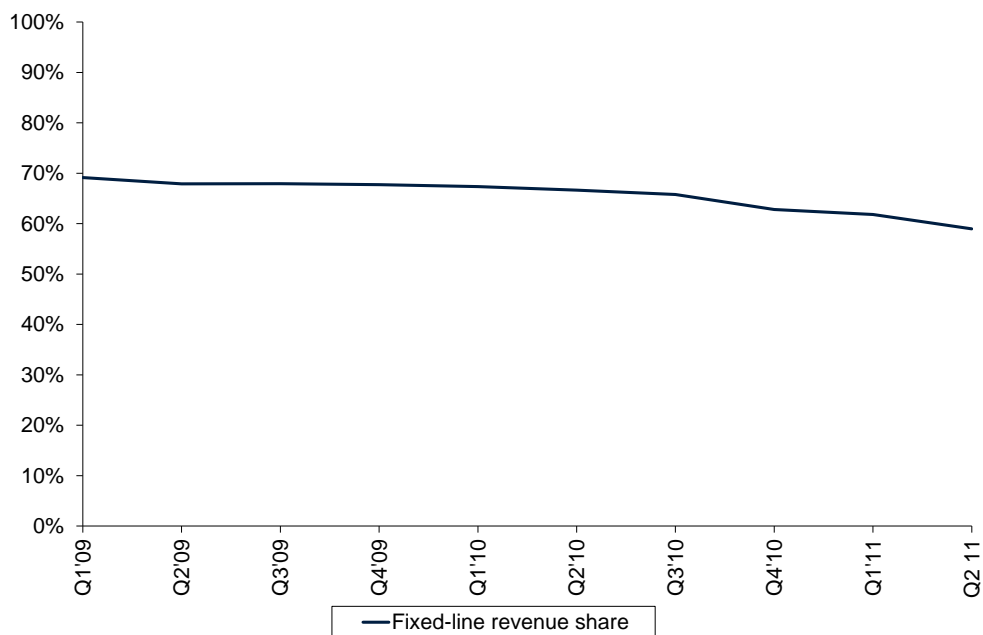
This evidence shows that eir’s revenue yield remained relatively stable, and its revenue or market share, i.e. share of fixed-line activities by revenue, in this period, remained high at 62%.

Note: <sup>1</sup> Decision 42 (6) refers to changes in market share and/or changes in related markets. We have focused our analysis on changes in market share only.

#### 4.3.1 Changes in eir’s share of fixed-line market share by revenue

Figure 4.4 shows eir’s fixed-line market share by revenue. It indicates that eir’s share of fixed-line revenues was high, but slightly decreased relative to previous financial periods, with customers moving to other companies in the presence of regulated access to eir’s fixed network.<sup>30</sup>

Figure 4.4 Changes in eir’s fixed-line market share by revenue



Note: Fixed-line market share by revenue calculations are based on total external revenue data provided by ComReg.

Source: Oxera analysis based on revenue data provided by ComReg.

We note that eir’s fixed-line market share by revenue remains high at around 62% for the period of the application, 2010/11. The high proportion of the fixed-line revenue share is consistent with eir’s level of profitability, as analysed in the previous section.

<sup>30</sup> It should be noted that since eir’s revenue share has declined slightly over the period of analysis, this reflects a relative decline in its customer base (i.e. a switch to other network service providers). This is distinct from an absolute decline in its customer base, for which there is also some evidence, i.e. a slight fall in total customer numbers, as shown in Figure 4.6.

### 4.3.2 Changes in revenue yield over time

Figure 4.5 presents annual average revenue per user (ARPU) over time (i.e. 2009/10 and 2010/11).<sup>31</sup> The data shows for the particular year of application retail revenue per user increased while the revenues generated from wholesale customers decreased, such that the total ARPU has remained stable.

#### Figure 4.5 Revenue yield movements for eir over time

[X]

Note: Total ARPU is total revenue/total number of customers.

Source: Oxera analysis based on eir's submissions to ComReg.

Figure 4.5 indicates that eir's performance in terms of its ability to gain revenue from its customers (i.e. total ARPU) was stable in 2010/11 relative to the 2009/10 financial year (i.e. [X] increase).

### 4.3.3 Changes in the number of customers

Figure 4.6 shows that there was an overall decline in the number of eir total customers from 2009/10 to 2010/11 (i.e. [X] decline). This decline is due to the fall in retail customers, which was not offset by a corresponding increase in the number of wholesale customers.

#### Figure 4.6 Changes in eir customer numbers

[X]

Source: Oxera analysis based on eir's submissions to ComReg.

Overall, the analysis presented in this section 4.3 suggests that eir has faced increased competitive pressure in 2010/11, as evidenced by its decline in total customers. Nonetheless, its revenue yield remained stable, and its fixed-line market share by revenue in this period remained high at 62%.

## 4.4 Summary

The analysis presented in Section 4 addresses ComReg's Decision 40,<sup>32</sup> which requires an assessment of whether the net cost of the USO significantly affects a USP's profitability and/or ability to earn a fair rate of return on its capital employed.

The results of Oxera's assessment showed that:

- profitability (measured by ROCE) in 2010/11 was 26.1% in the fixed-line business. Without the net cost, profitability would have been 26.7%;
- profitability in 2010/11 was higher than the allowed regulated return for the fixed-line business, the WACC, directed by ComReg to be 10.21%, from a range of 7.77–11.08%;

<sup>31</sup> In the context of this analysis, ARPU is a relevant measure of price, or revenue yield per customer. This is because there may be fixed and variable charges for different telecommunication services that are not directly comparable (e.g. price per unit of data, or per minute of voice call). The measure of average revenue yield per customer allows for comparison of prices over time.

<sup>32</sup> Given that the analysis presented in this section shows that the net cost does not significantly affect eir's profitability and its ability to earn a fair rate of return on its capital employed, Oxera has not therefore applied Decision 41 (i.e. whether the net cost materially impacts eir's ability to compete on equal terms with competitors going forward).

- for there to be no returns above the WACC for the fixed-line business, the net cost of the USO would have to have been around 31 times higher or, alternatively, the absolute profit (EBIT) for the fixed-line business would have to have been 61% lower;
- eir was well positioned to internalise the cross-subsidy in providing the USO.
- the net cost of the USO was around 0.62% of revenues, or 2.0% of EBIT in 2010/11;
- eir's share of revenues generated from fixed-line activities remained high in 2010/11. Its fixed-line market share by revenue in this period was 62%;
- eir's revenues were not significantly affected by a change in the market ARPU. Total average revenues per user increased by around [X] compared with 2009/10.
- eir's total number of customers declined from 2009/10 to 2010/11 (i.e. [X] decline) due to a decline in retail customers, which was not offset by a corresponding increase in the number of wholesale customers.

In summary, having analysed eir's financial position and having considered indicators of eir's economic situation which illustrate the context of the fixed line market in which eir operates and serve as broader context for the profitability analysis, we find that eir's profitability and ability to earn a fair rate of return on capital employed have not been significantly affected by the net cost of the USO and, therefore, that the burden of the net cost in the period of application was not excessive in view of eir's ability to bear it.

We find that the net cost of the USO did not represent an unfair burden on eir in 2010/11.

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## **5 Conclusions—is the net cost of the USO in 2010/11 an unfair burden?**

This section sets our conclusion to inform ComReg's determination.

This report has considered whether the net cost of the USO represented an unfair burden on eir in the period of application.

Our analysis shows that eir's profitability and ability to earn a fair rate of return on capital employed have not been significantly affected by the net cost of the USO and, therefore, that the burden of the net cost was not excessive in view of eir's ability to bear it.

Oxera concludes that the net cost of the USO did not represent an unfair burden on eir in 2010/11.

Our analysis is summarised in Table 5.1 below.

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**Table 5.1 Unfair burden analysis summary 2010/11**

**Decision 39 (Administrative cost assessment)**

**Observations**

**Conclusion**

If the positive net cost is relatively small, ComReg will determine, on the basis of audited costs of the USO, whether USO financing is or is not justified, taking into account the administrative costs of establishing and operating a sharing mechanism (compared to the positive net cost of the USO) and taking into account whether these costs are disproportionate to any net transfers to a USP.

**Section 3:**

- eir estimates the net cost of the USO for 2010/11 at €7.9m, while Oxera's analysis as part of the 2009/10 application indicated that the administrative cost of a sharing mechanism was likely to be in the region of €0.4m.
- The net cost of the USO was not small relative to the costs of a sharing mechanism.

**Conclusion (Decision 39)**—the net cost of the USO in 2010/11 was material compared to the administrative costs of establishing and operating a sharing mechanism. The net cost of the USO was also significantly higher than an estimate of the net transfer to the USP, were a sharing mechanism to be established. As a result, it would be proportionate to establish a sharing mechanism if it was found that the provision of the USO in 2010/11 represented an unfair burden on the USP.

**Decision 40 (Assessment of the USP's financial position)**

**Observations**

**Conclusion**

If the positive net cost is not relatively small, ComReg will assess whether or not this net cost significantly affects a USP's profitability and/or ability to earn a fair rate of return on its capital employed.



	<b>Observations</b>	<b>Conclusion</b>
<i>Relevant indicators include:</i>		
Changes in profitability, including an understanding of where a USP generates most of its profits over time—Decision 42 (1)	<b>Section 4.1:</b> <ul style="list-style-type: none"><li>eir's fixed-line business was profitable over the period of analysis (i.e. 2010/11).</li><li>Profitability (measured by ROCE) in 2010/11 was 26.1% in the fixed-line business. Without the net cost, profitability would have been 26.7%.</li><li>For there to be no returns above the WACC for the fixed-line business, the net cost of the USO would have to have been around 31 times higher or, alternatively, the absolute profit (EBIT) for the fixed-line business would have to have been 61% lower.</li><li>Given the level of profits that was being earned within the fixed-line business in 2010/11, eir had the ability to cross-subsidise the provision of the USO by using profits that were earned in segments of the fixed-line business.</li></ul>	<ul style="list-style-type: none"><li>eir's returns were in excess of the competitive benchmark or a 'fair rate of return' as measured by the regulatory allowed WACC, including the upper end of the WACC range estimated by ComReg for the relevant period.</li><li>eir was well positioned to internalise the cross-subsidy in providing the USO.</li></ul>
Changes in accounting profits and related financial measures—Decision 42 (2)		
Estimates of average level of cross-subsidy between classes of more or less separately accounted for services, and changes in these over time—Decision 42 (4)		
Changes in market share and/or changes in related markets—Decision 42 (6)	<b>Sections 4.3.1, 4.3.3:</b> <ul style="list-style-type: none"><li>eir's share of revenues generated from fixed-line activities remained high in 2010/11. Its share of fixed-line activities by revenue in this period was 62%.</li><li>There was a decline in the number of total eir customers from 2009/10 to 2010/11 (i.e. [x] decline), due to a decline in retail customers (notwithstanding an increase in wholesale customers).</li></ul>	<ul style="list-style-type: none"><li>A decline in the total number of customers could reflect an increase in competitive pressures that could affect profitability.</li></ul>
Changes in prices over time—Decision 42 (5)	<b>Section 4.3.2:</b> <ul style="list-style-type: none"><li>eir's revenues were not significantly affected by a change in the market ARPU.</li><li>Compared with 2009/10, total ARPU increased by around [x].</li></ul>	<ul style="list-style-type: none"><li>The level of ARPU in 2010/11 compared with 2009/10 remained relatively stable.</li></ul>

## Observations

## Conclusion

**Conclusion (Decision 40)**—having assessed that the net cost of the USO was not small relative to the administrative costs of a sharing mechanism (Decision 39), and having regard to the criteria outlined in Decision 42, Oxera has analysed the USP's financial position. eir's fixed-line business was profitable and its returns were high over the period of the analysis. eir's returns remained in excess of the competitive benchmark or a 'fair rate of return' as measured by the regulatory allowed WACC, including the upper end of the WACC range estimated by ComReg. Given the level of profitability in the fixed-line business, eir was also well positioned to internalise the net cost of the USO. Oxera also considered economic indicators such as eir's pricing and fixed line market share by revenue, which illustrate the context of the fixed line market in which eir operates and serve as broader context for the profitability analysis. We note that in the application period eir faced an increase in competitive pressures. However, eir's ARPU remained stable and eir was able to retain a majority market share by revenue in the fixed-line market. Overall, we find that eir's profitability and ability to earn a fair rate of return on capital employed have not been significantly affected by the net cost of the USO. Therefore, we find that the burden of the net cost was not excessive in view eir's ability to bear it and that the net cost in 2010/11 did not represent an unfair burden on eir.

## Conclusion and summary

**eir's financial position indicates that the provision of the USO did not represent an unfair burden.**

**Notwithstanding a decline in its total number of customers, eir's average revenue per user was stable in 2010/11 relative to 2009/10 and it retained a majority market share by revenue in the fixed-line market and it was well positioned to internalise the cross-subsidy in providing the USO. For the application year 2010/11, eir provided the USO while earning profits that were in excess of a competitive benchmark. Therefore, eir's profitability and ability to earn a fair rate of return on its capital employed have not been significantly affected by the net cost of the USO. The results of our analysis in Section 4 show that, taking into account eir's individual characteristics, the burden of the net cost was not excessive in view of eir's ability to bear it, and that the net cost in 2010/11 did not represent an unfair burden on eir.**

## A1 The scope of the relevant business

In understanding the impact of accounting profits, it is necessary to define a relevant scope for the business. Oxera has assessed that for the analysis carried out in section 4 of this report the appropriate business level is the fixed-line business that includes all of eir's integrated fixed-line business, including wholesale and retail, and business and residential, including data communications and interconnection services. Mobile services are excluded from this business scope. Informed by discussions with ComReg, in Oxera's view the activities included in the integrated fixed-line business are characterised as being not dissociable from the USO.<sup>33</sup>

### A1.1 Options for the scope of the relevant business

It is necessary to identify a scope of eir's business for which profitability can be assessed in order to examine whether the net cost has a significant impact on eir's profitability and its ability to earn a fair rate of return on capital employed (ROCE). The three options for profitability analysis are as follows:

- **the core 'USO business'**. This would include the regulated wholesale components of eir's business that operate the USO network, and the related USO retail business.<sup>34</sup> This would exclude unregulated wholesale and retail activities, and Meteor and other subsidiaries;
- **the 'fixed-line business'**. This would include all of eir's integrated fixed-line business, including wholesale and retail, and business and residential, including data communications and interconnection services. Mobile services would be excluded;
- **the group level**. This would include the telecoms and directly related activities undertaken by eir group, both regulated and unregulated, mobile and fixed. In principle, it would exclude any businesses that are completely unrelated to the telecoms business. At present, such businesses represent a small share of total eir revenue.

These options were considered in an earlier Oxera report, Oxera (2013a), produced in the context of ComReg's assessment of eir's application for USO funding for its financial year 2009/10.<sup>35</sup> In that report, it was decided that the appropriate business level for analysis is the fixed-line business, and this remains Oxera's position for the 2010/11 application under consideration.

For completeness, the ROCE estimates for the three levels of eir's business in 2010/11 are set out in the table below.

<sup>33</sup> In particular, Oxera and ComReg reviewed the following products included in the fixed-line business and concluded that these are characterised as being not dissociable from the USO: 'Wholesale Residual (Unregulated)', 'Retail voice calls', 'Retail broadband', 'Leased lines', 'Data services', 'Apparatus Supply', 'Legacy Operator Services', 'Value Added Voice', 'Value Added Non-Voice', 'Directory Enquiry', 'Public Payphones', 'Other Remaining Activities' and 'Other Internet Services'.

<sup>34</sup> As per the historical cost regulatory separated accounts for 2010/11, Oxera assumes that this USO business would comprise the Wholesale Regulated and Retail PSTN & ISDN Access business.

<sup>35</sup> Oxera (2013a), op. cit.

**Table A1.1 ROCE for the core USO business, fixed-line business and group-level business**

	USO business	Fixed-line business	Group
2010/11	14.8%	26.1%	13.0%

Note: The group performance was affected by a one-off exceptional cost of €138m that occurred in the Meteor business in 2010/11.

Source: Oxera analysis based on eir's historical cost regulatory separated accounts.

### **A1.2 Why the fixed-line business has been chosen for Oxera's analysis**

In theory, an economic assessment of whether the net cost has an impact on profitability should reflect all parts of the business that are not dissociable from the USO activities. While the net cost must be calculated with reference to the scope of the universal service itself, the analysis of its impact on eir should take into account the relevant parts of its integrated business. This needs to include consideration of the extent to which the finances of the remainder of the fixed-line business are affected by the same factors that are causing a net cost, and therefore how eir's profitability as the USP is best measured. This assessment includes costs that are incurred indirectly as a result of the USO, even if they are not allocated to USO products, and revenues from other services that are offered over the USO network and therefore contribute to the financing of the USO. For example:

- retail activities that do not rely on the USO (such as the provision of equipment) could be excluded;
- retail activities that are provided alongside regulated USO services (such as PSTN calls) could be included.

In an earlier Oxera report, Oxera (2013b), we considered this in more detail, and concluded that the integrated fixed-line business appeared to include businesses that were largely consistent with the economic principle of not being dissociable from the USO, with some exceptions that were less clear.<sup>36</sup> However, overall, the profitability of the fixed-line business represented a good proxy for the profitability of the businesses that could be directly linked to the USO network.

We consider that it would not be proportionate to undertake a more detailed 'line-by-line' assessment of the ROCE of sub-divisions within the fixed-line business. This is because a line-by-line assessment would require a judgement about the extent to which they are dissociable from the provision of the USO. Even if it were possible to conclude about the proportion of each sub-division that is not dissociable from USO provision, the available financial data for sub-divisions may not allow for meaningful ROCE estimation. This is because the audited financial accounts for eir are not sufficiently granular in reporting revenues, cost allocation and capital employed by sub-division.

Also, it would be difficult to clearly split a single service provided by eir (e.g. broadband) into underlying wholesale and retail components. In particular, eir's historical cost accounts use wholesale transfer charges to allocate wholesale costs across different products. This suggests that eir's own estimate of transfer charges would have a significant impact on implied profitability in wholesale and retail parts of the business, while not affecting the total profitability of the company. In addition, the fact that eir has to rely on transfer charges to allocate its profitability across different segments of the business provides further support

<sup>36</sup> See Oxera (2013b), op. cit.

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to the conclusion that the activities included within the integrated fixed-line business are characterised as being not dissociable from the USO. Oxera has therefore based its profitability analysis on the fixed-line business.

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