Commission for
Communications Regulation

Response to Consultation

Response to consultation and draft direction on retail minus wholesale price control for the WBA market

Document No:	**05/88**
Date:	**23 November 2005**

An Coimisiún um Rialáil Cumarsáide
Commission for Communications Regulation
Abbey Court Irish Life Centre Lower Abbey Street Dublin 1 Ireland
Telephone +353 1 804 9600 *Fax* +353 1 804 9680 *Email* info@comreg.ie *Web* www.comreg.ie

Contents

1 Executive Summary

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

ComReg proposed to address the competition problems identified in the market by applying a retail minus price control. The objective of the consultation was to develop a methodology for calculating retail minus which would be transparent in its methodology and operation, and which would offer greater predictability to the market. Applying this methodology, an amendment to the existing interim price control framework would be proposed[1].

Responses to the consultation were received from the following organisations:

- Alto
- BT Ireland
- Digiweb
- Eircom
- Ireland Offline
- Netsource

ComReg thanks all respondents. Their views have been carefully considered, and have informed the conclusions and draft decision notice put forward in this document.

ComReg's overall conclusions can be summarised as follows:

- the control will be applied ex ante rather than ex post. An ex ante control will preclude a potential margin squeeze, and will offer greater predictability for investment, and transparency in implementation and operation

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

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

- eircom's costs and revenues will be used as the basis for establishing those of a similarly efficient operator[2], and these will be modified to take account of differences in scale, costs which would be borne by efficient new entrants but not by eircom, and of the evolution of prices

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

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

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

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

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

- Where eircom is supporting multiple retail products from a single wholesale product, ComReg believes it is appropriate when assessing compliance with the wholesale price control to use the weighted average (by number of subscribers) of the retail products as the reference point for the retail minus control.

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

Appendix A includes a list of the draft directions. A draft of the control mechanism is included as Appendix B. ComReg welcomes comments on its draft directions and the draft control mechanism. The consultation period will run until 21 December 2005.

[2] Defined in the "consultation issue leading to Q2" in Section 4.2 as an operator "which shared the same cost function as eircom's own downstream businesses but which did not yet necessarily enjoy the same economies of scale and scope as eircom's overall business."

2 Introduction

3.1 Background

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

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

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

In Document 05/11r[3] (following on from its definition of the Market and its designation of eircom as having SMP in the Market), ComReg imposed an interim ex ante retail minus price control on eircom. ComReg indicated that this would be an interim measure that would apply until a subsequent consultation on a replacement price control was completed and ComReg issued a new direction on the application of a retail minus control in the Market.

ComReg published its Consultation[4] on a retail minus price control for the WBA market on 19 August 2005. The consultation period ran until 16 September 2005. ComReg received responses from the following organisations:

- Alto
- BT Ireland
- Digiweb
- Eircom

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

[4] Document No 05/67; published 19/08/05 – **Consultation on retail minus price control for WBA Market**

- Ireland Offline
- Netsource

ComReg thanks all respondents for their submissions. Having considered the views of all respondents, ComReg sets out in this document its conclusions regarding the implementation of a retail minus price control in the form of a draft directions and a draft control mechanism. ComReg is consulting on the measures contained in the draft directions and the draft control mechanism. The consultation period will run from 23 November 2005 until 21 December 2005.

2.1 Regulatory objectives under the Communications Regulation Act, 2002

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

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

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

2.2 Regulatory Framework

Four sets of Regulations,[5] which transpose into Irish law four European Community directives on electronic communications networks and services,[6] entered into force in

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

[6] The new regulatory framework for electronic communications networks and services, comprising of Directive 2002/21/EC of the European Parliament and of the Council on a common regulatory framework for electronic communications networks and services, ("*the Framework Directive*"), OJ 2002 L 108/33, and four other Directives (collectively referred to as "the Specific Directives"), namely: Directive 2002/20/EC of the European Parliament and of the Council on the authorisation of electronic communications networks and services, ("*the Authorisation Directive*"), OJ 2002 L 108/21; Directive 2002/19/EC of

Ireland on 25 July 2003. The final element of the European electronic communications regulatory package, the *Privacy and Electronic Communications Directive*, was transposed into Irish law on 6 November 2003.

The new communications regulatory framework requires that ComReg define relevant markets appropriate to national circumstances, in particular relevant geographic markets within its territory, in accordance with the market definition procedure outlined in the *Framework Regulations*[7].

2.3 Structure of Document

The remainder of this document is structured as follows:

Section 3 summarises the views of respondents and outlines ComReg's conclusion on each of the questions posed in the consultation.

Section 4 outlines the Regulatory Impact Assessment.

Appendix A gives a list of Directions and Decisions.

Appendix B is a draft direction which includes the proposed wholesale retail minus price control mechanism.

Finally, Appendix C gives a description of the discounted cash flow model.

---

the European Parliament and of the Council on access to, and interconnection of, electronic communications networks and services, ("*the Access Directive*"), OJ 2002 L 108/7; Directive 2002/22/EC of the European Parliament and of the Council on universal service and users' rights relating to electronic communications networks and services, ("*the Universal Service Directive*"), OJ 2002 L 108/51; and the Directive 2002/58/EC of the European Parliament and of the Council concerning the processing of personal data and the protection of privacy in the electronic communications sector, ("*the Privacy and Electronic Communications Directive*"), OJ 2002 L 201/37.

[7] Framework Regulation 26.

3 Decision Notice Issues

3.1 Context

In the last consultation, ComReg outlined the context within which it was considering the application of a retail minus price control. In summary, ComReg's view was that the objective of a price control was to prevent a vertically integrated operator with SMP at a wholesale level engaging in a margin squeeze to gain market power in the downstream retail market.

One respondent expressed a view that the potential for a margin squeeze was low, because there was little advantage for the SMP operator. In the consultation paper, ComReg set out its view on the incentives for a vertically integrated SMP operator to engage in margin squeeze. This view was supported by all other respondents, some of whom provided examples of perceived margin squeezes.

ComReg therefore maintains its view that a price control is necessary in this market because of the market conditions identified in the market review[8], and notes industry support for this perspective. Furthermore, ComReg maintains its view that of the available forms of price control, a retail minus price control is the most appropriate.

3.2 Response to consultation questions

Responses to each of the questions raised in the consultation are summarised below. In relation to each question, ComReg has summarised the consultation issue, restated the question, followed by a summarised version of the key points raised by respondents and ComReg's position on the issue. ComReg has carefully considered all responses in order to form its conclusions. Subsequent to the publication of this paper, ComReg will publish non-confidential versions of all submissions received in line with its standard practice.

3.2.1 Principles of ex ante and ex post application of retail minus

Consultation issue leading to Q1

In the consultation, ComReg outlined the advantages and disadvantages associated with ex ante and ex post approaches. It was ComReg's proposal that ex ante measures were required to prevent vertical leveraging by means of a margin squeeze in the WBA market, and to ensure that competition became established.

ComReg's analysis in the WBA market review concluded that the wholesale market was not effectively competitive, and that regulatory intervention was required to address this. It was seen as unlikely that ex post regulation would be sufficient to ensure that eircom did not leverage its SMP in the wholesale market into the potentially competitive downstream market. This was because ex post measures

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

generally address the abuse of a dominant position, rather than the holding of a dominant position. Specifically in this market, this means that by the time problems associated with margin squeeze were recognised and reported, and an ex post test was carried out, market share could already be secured by a vertically integrated firm, and alternative market entry prevented. In determining that a market should be subject to ex ante regulation, the European Commission in its Recommendation on Relevant Markets[9] has already concluded that competition law is insufficient to address the competition failures identified.

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

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

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

ComReg noted that the principles of transparency and predictability are important, and that these principles would best be achieved by implementing an ex ante approach.

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

Views of respondents

Five respondents agreed that an ex ante retail minus test was appropriate and proportionate. Respondents noted that the market was not effectively competitive,

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

and believed that eircom was dominant in the wholesale and retail markets. It was indicated that an ex post test would not be enough to prevent margin squeeze, as market entry could be deterred before detection.

One respondent, who agreed that an ex ante test should be carried out, expressed concern about the limitations and boundaries of the test proposed by ComReg. It was suggested that the test should address all elements of the cost structure, as otherwise, the margin squeeze could be applied at a different charging point. This issue was picked up by another respondent who asked for clarity and transparency in the definition of the retail product.

One respondent did not agree that an ex ante retail minus test was appropriate, primarily because of the risk of false positives[10]. This respondent proposed that a false positive would lead to inefficient entry in the down stream market. The respondent believed that current bitstream prices were more than sufficient to maintain a margin which would sustain competition.

ComReg's position

As stated in the consultation paper (ComReg 05/67), ComReg believes that eircom, as a vertically integrated operator, has a clear incentive to squeeze margins[11]. ComReg has considered carefully the implications of carrying out an ex ante and an ex post approach. An ex ante approach increases transparency and predictability for all operators, and precludes the possibility of margin squeeze. However, it is more burdensome on the regulated firm and on the regulator, and may delay product innovation. An ex post approach would be more flexible, and less burdensome on both the regulator and the regulated operator. Its key disadvantage is that by its nature it is applied after the event, by which time market share may already be secured, or market entry prevented.

ComReg is very clear that the eventual aim is to have an effectively competitive broadband market. At some point in the future, as the market moves towards effective competition, it is possible that an ex post test would be the appropriate way to test for any perceived margin squeeze. However, the analysis of the WBA market in Ireland indicated conclusively that the broadband market was not yet effectively competitive. Because of the current status of the broadband market, and given the very real possibility of foreclosure at the retail level, ComReg maintains its view that its regulatory objectives would be best served by adopting an ex ante approach.

---

[10] This is sometimes known as a "Type 1 error" – where a margin squeeze is not taking place, yet because of using incorrect information (perhaps that the costs attributed are incorrect) the regulator concludes a margin squeeze exists. ComReg is aware of this problem, and is taking steps to avoid it. However, it should be pointed out that there are also "type 2 errors", where a margin squeeze is taking place yet the regulator concludes that it is not. This is also harmful as it would result in efficient entry being deterred and consequent harm to competition and consumers.

[11] Refer to Section 3.3 of Document No 05/67; published 19/08/05 – **Consultation on retail minus price control for WBA Market**

ComReg returns to the points raised by respondent in relation to the cost structure and the definition of what constitutes a new product in its response to Q5 and Q15 respectively.

Decision No. 1. An ex ante retail minus test will be applied.

3.2.2 Similarly efficient operator

Consultation issue leading to Q2

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

ComReg considered that the appropriate conceptual approach for the margin squeeze analysis would be to establish a margin which would allow a similarly efficient operator to enter the market today, to incur the relevant start-up costs and initial losses and still expect to be able to recover costs over a reasonable period of time, and to compete effectively with eircom in the broadband services market.

ComReg recognised that in making adjustments to costs and applying the margin squeeze framework to a similarly efficient operator, it needed to avoid promoting inefficient entry, and to avoid the distortion of incentives to invest in infrastructure.

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

Views of respondents

All respondents agreed that the concept of a "similarly efficient operator" should be the benchmark for a market squeeze analysis.

One respondent proposed that, in order to avoid distorting the incentive to invest in LLU or in direct connection, the appropriate benchmark was an operator with the same economies of scope as eircom.

However, another respondent believed strongly that ComReg should be setting a margin which was reasonable for the WBA market in its own right, without reference to the LLU market. The respondent suggested further that an approach which used considerations from the LLU market in setting margins for WBA could promote inefficient entry to LLU.

ComReg's position

ComReg notes general agreement that the concept of a "similarly efficient operator" should be used as a benchmark for a margin squeeze analysis.

Several respondents raised concerns about the linking of regulatory policy on LLU with regulatory policy on broadband. ComReg's discussion of LLU was in the context of perceived longer term development of the market for the provision of broadband services, and it remains essential that a price control does not distort incentives to invest in infrastructure by operators.

Decision No. 2. A "similarly efficient operator" constitutes an appropriate benchmark for a margin squeeze analysis.

3.2.3 Dynamic issues – historic costs or forecasted future costs?

Consultation issue leading to Q3

ComReg proposed that it was appropriate in this market to apply retail minus based on current data and judgements about future variables.

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

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

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

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

Views of respondents

All respondents agreed that an appropriate approach would consider future costs and revenues. It was noted generally that a balance was needed between incorporating current data and understanding that a forward looking approach would need to include judgements about a range of potential developments in the market. One respondent suggested that experience with the development of the broadband market in other countries should be considered. Another suggested sunk costs should be included as part of the true cost of supply, and also that the accuracy of eircom's previous forecasts should be considered when assessing new forecasts.

ComReg's position

ComReg welcomes support for this proposal, and will take into account practical suggestions made by respondents.

ComReg believes that in determining the appropriate margin, ComReg should model the costs of a hypothetical new entrant growing the business to maturity. This will entail the use of forward looking assumptions on the evolution of costs and revenues. However, in making these forecasts, ComReg will take account of recent and current evidence of costs and revenues actually incurred by operators.

ComReg shares the concerns of one respondent in relation to sunk costs. However ComReg believes that the basis for setting margins should be the costs incurred by a theoretical new entrant rather than those incurred by eircom's retail operation and therefore the issue of sunk costs will not arise.

Decision No. 3. Future costs and revenues will be used in ComReg's analysis.

3.2.4 Discounted cash flow analysis

Consultation issue leading to Q4

ComReg proposed to use a DCF method to assess margins. The proposed approach would use eircom's costs – both historic and forecast – as a data source, but would adjust these costs to reflect the position of a market entrant today.

ComReg noted that a DCF approach is often used to assess business investment decisions. It uses the future value of cash flow projections and discounts them to arrive at a present value. An investment is worthwhile if the sum of the DCFs is non negative.

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

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

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

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

Q. 4. Do you agree that a discounted cash flow (DCF) method should be used to assess margins?

Views of respondents

All respondents agreed that a DCF method should be used. One respondent proposed that other techniques such as internal rate of return (IRR) should be used in addition to DCF, and that the analysis should apply to all elements of the cost structure such as backhaul and service fees. Another respondent expressed a view that ComReg should consider actual costs of an efficient operator, and that its view was that eircom was not an efficient wholesaler.

ComReg's position

ComReg welcomes support for the use of a DCF method in the analysis. ComReg's proposed approach involves a modelling exercise which will use eircom's costs as a basis from which to build the hypothetical costs of a similarly efficient operator. In performing a DCF analysis, ComReg has taken account of all the costs incurred by an operator availing of the bitstream service (including backhaul). For clarification, a DCF analysis should return the same result as IRR (as IRR is the discount rate where the NPV of the cash flows equals zero) but is simpler and does not return multiple solutions as IRR can sometimes do.

Decision No. 4. A discounted cash flow model will be used to assess margins.

3.2.5 What time horizon?

Consultation issue leading to Q5

ComReg proposed that it was reasonable to carry out the DCF analysis over a five year period and truncate the analysis at that point with the inclusion of terminal values. The consultation outlined the need to balance the requirement for a sufficient length of time for an entrant to recover legitimate losses against the issue of reliability of forecast data.

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

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

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

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

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

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

Views of respondents

Respondents had mixed views. Two respondents believed that five years was appropriate. The remaining four respondents believed that a five year assessment would be prone to error, and noted the rapidity of change in the market. It was proposed that three to four years was a better option.

ComReg's position

ComReg recognises that the selection of time period for the DCF analysis has to balance the risks between taking a view that is too short against the risks of a view which is too long. ComReg has considered the views of respondents and concluded that five years is the minimum credible period to model a hypothetical operator from entry in the market to maturity in the market. This will minimise the risk of forecasting error, while still allowing time to consider the growth pattern of new entrants, and is appropriate for a rapidly changing market.

ComReg is also advocating an annual review to verify if the modelling assumptions and parameters have changed. This is elaborated in ComReg's response to Q7.

Decision No. 5. The discounted cash flow analysis will be carried out over five years.

3.2.6 Terminal value

Consultation issue leading to Q6

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

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

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

Views of respondents

Four respondents commented on this issue. One did not think that it was appropriate to apply a terminal value because costs associated with selling bitstream are more concerned with operating costs than capital costs. Another respondent proposed that if a DCF was carried out over a five year period, the terminal value would tend towards zero, because investment in retail markets which did not involve infrastructure would be made with an expectation of profit within a five year period.

One respondent proposed the use of the Modern Equivalent Asset method.

Another respondent proposed that the most appropriate method was to add the cash flow of the five years covered by the DCF analysis to three subsequent stable years, and then close the business. It was the respondent's view that in a dynamic broadband market, prices would drop towards the competitive over five years, so that the free cash flow for three further years could be confidently forecast.

ComReg's position

ComReg has considered the views of respondents and concluded that a terminal value is required. ComReg acknowledges that there is artificiality in truncating a modelling period; in reality, customers are clearly acquired throughout the modelled period. These customers, especially those acquired towards the end of the modelling period would continue to contribute positive cash flows in future periods. Therefore, to exclude the revenue generated by these customers would artificially deflate the expected cash flows.

ComReg has considered a number of different methods of computing terminal values including those suggested by respondents. In addition ComReg has performed a benchmarking exercise looking at recent valuations of broadband ISPs. In light of the analysis performed, ComReg has concluded that using the net cash flow of the final year, carried forward for three subsequent years is an appropriate method of computing the terminal value.

Decision No. 6. ComReg will apply a terminal value. The terminal value will be calculated by using the net cash flow of the fifth year of the discounted cash flow analysis, carried forward for three subsequent years.

3.2.7 How often should the margin be reassessed?

Consultation issue leading to Q7

ComReg proposed that the retail minus control should be subject to annual review, but that significant changes in the market would initiate an immediate review.

The consultation considered whether the retail minus control should be invariant over a fixed period, and if so, how long. A range of options were examined. One option would be to review the appropriate margin every time there was a retail price change. While this would ensure that the control was highly responsive to the market, and that any changes in product or service offering could be accommodated, ComReg considered that this approach could not provide the level of predictability which is required by all operators. As the provision of greater certainty as regards the margin is a key purpose of proposing this measure, triggering a review each time there is a retail price change would not achieve the regulatory objectives.

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

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

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

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

Views of respondents

Respondents agreed with the principle of review. One respondent agreed with ComReg's proposal and proposed that a reasonable complaint should also trigger a review. A second respondent proposed that not only the margin but the whole structure of the price control should be reviewed frequently. A more frequent review was also proposed by another respondent. One respondent suggested that the timing of the review was less important than its transparency.

ComReg's position

The objective in establishing a structure for the review of the price control is to increase predictability in the market. ComReg therefore has concerns about a review period which was less than one year. Equally, given the uncertainties in the forecasting process, ComReg believes that leaving the review for longer than a year would be inappropriate.

ComReg does not feel it would be appropriate to trigger a review of the margins on receipt of a complaint. However, should an operator feel that eircom is acting in a manner that is inconsistent with the objectives of the price control, or is not in compliance with its obligations, that operator is entitled to raise a formal dispute on the subject with ComReg.

In respect of one respondent's point that not only the margin but the whole structure of the price control should be reviewed frequently, ComReg believes this has some validity. Significant unforeseen developments in the market could require an amendment to this control. Therefore, ComReg will continuously monitor the functioning of the control and may from time to time amend it if necessary. Additionally, on the first annual review of the margins, ComReg will consider the functioning of the control in light of practical experience and may issue amendments if appropriate.

Decision No. 7. The margin will be subject to annual review. In the event of significant unforeseen changes in the marketplace, ComReg will review the price control and may issue amendments.

3.2.8 What discount rate should be applied?

Consultation issue leading to Q8

ComReg proposed that eircom's cost of capital would be used as a basis for calculating the relevant discount factor in the DCF analysis.

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

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

Views of respondents

Respondents had mixed views on this. Three respondents were generally in favour, but qualified this by proposing that the rate should be for new capital employed, or that adjustments should be made to reflect differences in market position.

Three respondents did not agree. One respondent suggested that eircom's weighted average cost of capital (WACC) was a return reflecting the risk of investing in infrastructure, which was a risk not incurred by a bitstream access seeker. For the latter, most business costs were seen as variable and the debt structure was likely to differ.

Two respondents proposed that a new OAO would have higher capital costs than eircom, and so eircom's costs would not be appropriate. It was noted that eircom was a long established utility and was active in all markets. Eircom would be considered low risk, and could access capital on more favourable terms than a new entrant.

ComReg's view

ComReg has reviewed the responses received and acknowledges the arguments for higher and lower discount rates than the one proposed in the consultation. During the sensitivity analysis performed as part of the DCF modelling exercise, it was noted that the outcome was not particularly sensitive to changes in the discount rate. ComReg has concluded that eircom's cost of capital is a useful benchmark that has been formally reviewed and approved under the price cap. Therefore, ComReg proposes to use it as the basis for the DCF analysis.

Decision No. 8. eircom's cost of capital will be used as the basis for calculating the discount factor in the discounted cash flow analysis.

3.2.9 Individual services or a portfolio?

Consultation issue leading to Q9

ComReg proposed to apply the ex ante retail minus framework on a product by product basis rather than on a portfolio basis.

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

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

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

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

Views of respondents

Five respondents agreed with this proposal. All noted that if the test were carried out on a portfolio basis, it would be possible to pass the test even if there were a margin squeeze on some individual components of the portfolio. One respondent stated that this approach was not just desirable but essential, and extended this to suggest that the entire cost of the product should be taken into account when applying the test.

One respondent did not agree that the margin squeeze test should be carried out on the basis of individual products. This respondent's view was that bitstream access seekers offered some services below cost in order to build market share, and that reductions in wholesale prices were anticipated in the pricing of retail offers. The respondent suggested that access seekers did not replicate eircom's retail offering, but built innovative solutions.

ComReg's position

ComReg has considered carefully the advantages and disadvantages of calculating the margin on the basis of a portfolio of wholesale products and on the basis of individual wholesale products. A portfolio approach would offer the regulated operator greater flexibility, and could promote greater innovation. However, a portfolio approach is necessarily less transparent, and risks an operator squeezing the margin on one product while remaining within the overall balance of the portfolio. An individual product approach offers less flexibility, but allows OAOs to enter niche markets.

ComReg's view is that a margin squeeze test at the level of individual wholesale products would preclude the possibility of a deliberate or inadvertent margin squeeze of elements of a portfolio, even when the overall portfolio passed a margin squeeze test. This approach would also fulfil the requirement for transparency, and is the most appropriate way to meet overall regulatory objectives.

Decision No. 9. The margin squeeze test will be conducted on the basis of individual products.

3.2.10 Wholesale products without retail equivalents

Consultation issue leading to Q10

ComReg proposed that wholesale products, without an equivalent retail product offered by eircom, should be excluded from the margin squeeze analysis.

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

In order to avoid distorting the market, ComReg proposed that these products should be priced in a manner consistent with the nearest equivalent wholesale product (which eircom does avail of at the retail level) suitably adjusted to reflect differences in functional characteristics.

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

Views of respondents

There were mixed views on this issue. Three respondents agreed with ComReg's proposal, and noted that ultimately OAOs sought to offer broadband services which fell into the same general category of products offered by eircom.

The respondents who disagreed did so for different reasons and proposed different solutions. One respondent believed that where a bitstream access seeker requested a wholesale product which did not have an eircom retail equivalent, then the price should be set by commercial negotiation. If there was no agreement, the functional characteristics of the product should be used to position the service in eircom's broadband portfolio.

The other respondents proposed that all products should be included in the margin squeeze analysis, by considering the retail product based on the nearest equivalent wholesale product suitably adjusted to reflect functional characteristics. It was suggested that this should be done on a compulsory basis rather than on "best endeavours". One of these respondents suggested that letting these products fall outside the scope of some form of control was more distorting to the market.

ComReg's position

ComReg has considered the views of respondents and supports the proposal by one respondent that in the first instance commercial negotiation should be used to determine the price of wholesale products not availed of by eircom retail. ComReg believes that the prices reached must be reasonable and if a reasonable price cannot be reached by commercial negotiation, ComReg will intervene to determine the price by reference to similar wholesale products suitably adjusted to take account of functional differences.

Decision No. 10. Commercial negotiation will be used to calculate the price for wholesale products that do not have an eircom retail equivalent. If such negotiation fails to determine a reasonable wholesale price, ComReg will intervene.

3.2.11 Retail prices

Consultation issue leading to Q11

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

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

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

ComReg suggested that real unit costs in this market are likely to fall, rather than increase, over time, and that competition among providers would reduce prices.

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

Views of respondents

Five respondents commented, and all agreed that sensitivity analysis should be performed. One of these respondents proposed that sensitivity of prices should be tested over at least 12 months.

ComReg's position

ComReg notes agreement that rates of decrease of retail prices should be subject to sensitivity analysis, and has taken this into account in arriving at its price controls.

Decision No. 11. ComReg will perform sensitivity analysis around rates of decrease of retail prices in doing its discounted cash flow evaluation of margins.

3.2.12 How should we approach costs?

Consultation issue leading to Q12

ComReg proposed to adopt a forward-looking approach which analysed economic costs and revenues over time.

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

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

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

Views of respondents

All respondents agreed. One respondent proposed that sunk costs should be included. Another respondent suggested that experience in other NRAs could be used to inform judgements about likely future developments.

ComReg's position

ComReg welcomes agreement on the overall approach. In relation to the respondent that raised the issue of sunk costs, ComReg has dealt with this issue in the section relating to Q3.

Decision No. 12. ComReg will use a forward looking approach in assessing costs.

3.2.13 Whose costs?

Consultation issue leading to Q13

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

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

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

An alternative approach would be to start from the costs which would be borne by a new entrant to the market, and to build a bottom-up model of a new entrant's costs. While this may appear to be a more realistic measure of the actual experience of a new market entrant, ComReg proposed that the cost assessment was more reliable if built on actual costs rather than hypothetical costs, and that eircom's cost profile provided the best starting point for the analysis.

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

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

Views of respondents

Five respondents agreed that eircom's costs were a suitable basis for establishing the costs of a similarly efficient operator, and respondents suggested adjustments which should be made to eircom's costs to reflect costs incurred by a new entrant but not by eircom. Respondents also suggested that experience in other countries could provide useful guidance on defining efficiency.

One respondent believed that the profile of the "similarly efficient operator" is crucial in determining what costs are included, and this respondent indicated that the costs should be those of a WBA operator.

ComReg's position

ComReg believes that its proposed approach to use eircom's costs as a starting point, and then to make adjustments which reflect the unavoidable costs of a similarly efficient new entrant, answers all concerns raised by respondents. In modelling the costs of a hypothetical new entrant, ComReg is simply using information from eircom as a source of benchmark data to ensure that the standard of similar efficiency is maintained.

Decision No. 13. eircom's costs should be used as the basis for establishing the costs of a similarly efficient operator.

3.2.14 Assessment of compliance - existing products

Consultation issue leading to Q14

ComReg proposed that in advance of eircom making a retail price change, it should be obliged to issue ComReg with a statement of compliance setting out the precise nature of the retail price change. The statement should demonstrate the corresponding adjustments which would be made to the wholesale prices such that compliance with the obligation was achieved. Once eircom had submitted such a statement to ComReg, it would be free to immediately notify wholesale operators of the wholesale price change without awaiting formal approval from ComReg.

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

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

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

Following receipt of a satisfactory statement of compliance, ComReg would only intervene if it found that the proposed changes in retail and wholesale prices were not in compliance with the price control obligation. If the proposed changes were not in compliance, ComReg would either initiate enforcement proceedings or direct amendments to the wholesale prices.

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

Views of respondents

Three respondents agreed with this proposal. Respondents noted that the proposal would encourage innovation in the market, and one respondent suggested that, in the interests of transparency, ComReg should publish the statement of compliance on its website. Another respondent, while welcoming the proposal, believed that operators did not need any advance notification of changes to products in the retail market because the "product" being considered is the wholesale product.

The respondents who did not agree with the proposal believed that operators should be notified of changes in the retail product before they came into effect, and the suggested period ranged from 15 to 20 working days.

ComReg's position

ComReg recognises the concerns expressed by some respondents, but emphasises that the proposal to withdraw advance notification applies to price changes, not to product changes, and was proposed with reference to changes to existing products.

ComReg has not defined a retail broadband market that is suitable for ex-ante regulation. Any notification to ComReg by eircom of retail price changes in advance of their implementation is solely for the purpose of assessing compliance with the wholesale price control. Should ComReg find eircom to be non compliant with the wholesale price control, any regulatory interventions by ComReg would relate only to wholesale prices.

It is ComReg's view that a transparent price control mechanism should make compliance straightforward, and that the proposed approach should encourage innovation and minimise delays.

Decision No. 14. See control in Appendix B.

3.2.15 New products

Consultation issue leading to Q15

It was proposed that prior to the introduction of new products, eircom should submit to ComReg a proposal setting out precise details of the new retail product and of the corresponding wholesale product[12]. Within a period of five working days ComReg would revert to eircom, either confirming that the proposal was in compliance with the obligation in which case eircom could proceed immediately to notify wholesale operators, or informing eircom that further analysis to determine compliance of the proposal was required. In this case, indicative timelines for that further analysis would be set out. During the five days subsequent to eircom making a proposal to ComReg or during a period of further analysis, eircom would be prevented from introducing new wholesale products.

In the case where eircom introduced new retail products, whether by changing the technical specifications of the product or by changing the basis of pricing[13] of the products, the assessment of compliance with the obligations would necessarily be less clear cut than is the case of amendments to existing products. There is a tension between the desire for transparency in the wholesale price control and the need to retain flexibility so as not stifle innovation. ComReg proposed that it would be impractical to try and create a wholesale price control that accommodated all potential innovations at the retail level in advance of their introduction. Therefore, in order to prevent a potential margin squeeze, it would not be sufficient to adopt the same assessment process as proposed for amendments to existing products in the case of the introduction of new products.

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

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

The process proposed by ComReg entailed eircom submitting, in advance of its introduction, details of any new retail product and its corresponding wholesale product. ComReg would revert within five working days, either by confirming compliance, or by indicating a timetable for further analysis

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

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

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

Q. 15. Do you believe that this proposal [eircom should submit details to ComReg of any new retail product and corresponding wholesale product; ComReg would commit to timescale for response] for price changes to new products is an appropriate mechanism for assessing the compliance of new products?

Views of respondents

Five respondents agreed in principle with ComReg's proposal. One of these stated that it was essential to have clarity in the definition of what constituted a retail product, and also what constituted a new product.

One respondent did not agree, and put forward the view that the only circumstance in which notification could be required would concern changes to the wholesale product. This respondent questioned what would happen should ComReg fail to meet its target response time.

ComReg's position

In the consultation, ComReg differentiated between changes to existing products and services, and the introduction of new products and services. While ComReg believes that it is appropriate to withdraw advance notification of price changes to existing products, it does not believe that the market is sufficiently mature to use this approach in addressing new products.

ComReg notes that there were some differences in interpretation amongst respondents. It can be clarified that this proposal refers to the introduction of a new retail product, and that the intention would be that eircom would submit price details of a new retail product and its corresponding wholesale product. ComReg would then have a 5 working day period where it would either approve the new product, or provide a timetable for its approval. Eircom would not be able to launch a new product without ComReg approval, whether this is granted within the 5 day period, or in line with the timescale produced. Therefore, eircom would not be able to launch a new wholesale product (including supplying to its own retail arm) prior to ComReg granting approval.

Decision No. 15.	**See control in Appendix B.**

3.2.16 Price control on connection fee

Consultation issue leading to Q16

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

ComReg acknowledged that there are fixed and variable elements to the cost stacks associated with the retail bitstream products. As discussed earlier, a DCF analysis was advocated for a defined period in order to take relevant account of the intricacies of the cost stacks and the product life cycle.

ComReg suggested in the consultation that it would be premature to consult on the appropriate size of the margin required for the wholesale price control. However, in the interests of transparency it was thought appropriate to consult on the form of the price control and to seek interested parties' views on whether ComReg proposals satisfied the requirements for transparency, predictability and flexibility while avoiding the possibility of margin squeeze during the life of this control.

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

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

Q. 16. Do you believe that this [wholesale connection charge as a fixed percentage of retail connection fee] is an appropriate form of price control for the connection fee?

Views of respondents

Five respondents were in favour of the proposal. One of these indicated that, in its view, the price control should apply to all service costs including backhaul. Another expressed concern that cost-based pricing for connection charges could act as a barrier to market growth, and suggested there may be scope to include part of the cost based charge in the rentals.

One respondent did not believe that movement in the retail connection fee should affect the recovery of the connection costs for bitstream. This respondent suggested that a price control for bitstream connection could consider the discounted costs represented by the bitstream connection and the rental charges over the customer life.

ComReg's position

ComReg notes the view of one respondent that the wholesale connection fee is potentially a barrier to competition. However, at its current levels, ComReg does not believe this to be the case. Moreover, ComReg believes that it is appropriate that there should be a discrete charge for connection, to reflect the discrete activities and costs associated with connecting a line, and does not believe that the costs associated with connections should be recovered through the recurring fees.

Another respondent suggested that the recovery of costs associated with wholesale connections should be unaffected by changes in retail prices. This respondent proposed that rather than have a separate price control for the connection, the costs to OAOs of the wholesale connection charge should be factored into the margin analysis. Having carefully considered the submissions to the consultation, ComReg believes that this proposal is superior to that set out in its consultation paper. ComReg believes that removing the linkage between retail and wholesale connection charges is both simpler and better reflects the principle of cost causation than its previous proposal. Clearly there is the potential for the costs of connection to the OAOs being greater than the revenue stream associated with retail connections. In order to avoid a margin squeeze, the costs associated with connection will have to be factored into the DCF analysis of margins and the margin between retail and wholesale rental charges will have to be sufficient to allow the recovery by the OAO of the costs of connection not recovered through retail charges.

ComReg will not impose a retail minus price control on the wholesale connection. In the absence of a retail minus control, ComReg believes that the cost for connection (or port transfer) should be cost oriented. To that end, eircom is directed to reduce the wholesale connection and port transfer prices from their current price of €60 to €30 effective from 1 January 2006. eircom shall not increase these charges without the prior approval of ComReg. ComReg would give approval for a change in this charge where there is an appropriate cost based justification.

Decision No. 16. The prices for wholesale connection and port transfer shall be cost oriented. From 1 January 2006, the price for wholesale connection and port transfer shall be €30. eircom shall not increase this charge without the prior approval of ComReg.

3.2.17 Price control on wholesale monthly rental

Consultation issue leading to Q17

ComReg proposed that the control should be a combination of a fixed monetary value and a fixed percentage.

ComReg considered three different mechanisms for the wholesale monthly rental price control.

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

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

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

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

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

ComReg proposed to set retail minus controls, in accordance with the formula above, for all current products. These controls would be applied by reference to the standard retail rental i.e. excluding promotions and discounts.

If eircom were to change any of the characteristics of either its retail or its wholesale products during the period of the control, it would be required to follow the approval and notification processes as described.

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

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

Views of respondents

Four respondents believed that ComReg's proposal was appropriate. It was noted that this was agreement in principle, as it was difficult to comment definitively in the absence of values.

One respondent questioned the treatment of commissions, and whether commissions could be used to circumvent the control. This respondent suggested that ComReg should treat commissions as a reduction in revenue.

One respondent, while agreeing that the general structure of the control was appropriate, proposed that a control should allow for movement in both connection and rental charges at the retail level in determining the wholesale rental. A separate control which isolated and linked retail and wholesale connection fees was therefore seen as inappropriate.

This respondent asked for clarification as to whether a single fixed percentage and money amount would apply to all products, or if separate parameters would apply to each wholesale/retail pair. The respondent also expressed a view that eircom was exposed to risks in recovering start-up costs just as were OAOs.

ComReg's position

ComReg welcomes the overall agreement with the format of the control proposed by ComReg during its consultation. As stated in response to Q16 the costs to OAOs of the wholesale connection fee will now be incorporated as part of this retail minus control.

In Q9, ComReg stated that a separate control will apply to each wholesale product A retail minus formula will be set for each of the current products on offer (excluding promotions and discounts which are dealt with in Q18 and Q19 respectively) with separately computed percentages and fixed monetary amounts. It should be noted that any given wholesale product could support two or more eircom retail products. Where eircom is supporting multiple retail products from a single wholesale product, ComReg believes it is appropriate when assessing compliance with the wholesale price control to use the weighted average (by number of subscribers) of the retail products as the reference point for the retail minus control.

As proposed in the consultation, where usage charges make up a significant portion of retail or wholesale prices, these charges will be converted into average monthly revenues and the control will be applied accordingly.

ComReg notes the concerns raised by one respondent in relation to commission payments. Commission payments are part of the costs of customer acquisition and ComReg believes that these costs should be factored into the DCF analysis of appropriate margins underpinning this control.

Decision No. 17. See control in Appendix B.

3.2.18 Retail discount schemes

Consultation issue leading to Q18

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

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

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

Q. 18. Do you think that this [new or amended discounts treated in the same way as new products] is an appropriate way to treat discounts? If not, please state clearly the reasons for your disagreement

Views of respondents

Five respondents generally agreed with this proposal. One emphasised the need for clarity and transparency in the definition of products and new products. Another suggested that OAOs should be given 15 working days' advance notice, during which time they could request that ComReg carried out a margin squeeze test, and a further respondent proposed a 20 working day advance notice period.

The respondent which did not agree proposed that revenues should be treated net of discount at both wholesale and retail levels when evaluating the margin on an ex post basis.

ComReg's position

ComReg welcomes the general agreement on this proposal and remains of the view that if eircom wish to amend or introduce a new discount scheme, it would require a submission prior to its launch in line with the procedure set out in response to Q15 for the introduction of a new product. ComReg notes the disagreement of one respondent and its suggestion that a margin squeeze test should be performed ex post, but ComReg has addressed this issue in its response to Q1.

To the extent that eircom can objectively demonstrate that a retail discount scheme is based on savings achieved at the retail level, as is the case with the current bulk order discount scheme, then retail discount schemes will not necessarily impact wholesale prices. However, where a discount scheme is not based on savings at the retail level, it would constitute a reduction in the retail price. In these circumstances, compliance with the retail minus control would be assessed on the weighted average of discounted and undiscounted lines.

In the event that eircom offer retail broadband as part of a bundle of services, where the price of the bundle is less than the price of the sum of the constituent elements, ComReg would regard this as a discount scheme being applied to broadband. It would therefore require eircom to make a submission prior to its launch. This submission would follow the same process as that set out for the introduction of a new product.

Decision No. 18.	**See control in Appendix B.**

3.2.19 Retail promotions

Consultation issue leading to Q19

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

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

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

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

Views of respondents

Several respondents, while generally supportive of the proposal, raised other issues and asked for clarification. One respondent requested more information about the rebate for OAOs and noted the free offerings that frequently accompany eircom promotions (such as an MP3 player). Another respondent asked how the mechanism would treat what it perceived as revenue foregone as a result of commissions offered to eircom's external sales channel, or as a result of bundling of broadband with other services. Another respondent expressed the view that retail promotions were likely to be frequent and would continue in the market. Its view was that where a retail promotion was matched by a corresponding wholesale promotion, then the wholesale rebate should be the revenue foregone at the retail level between the promoted prices and the standard prices.

One respondent did not accept that a wholesale promotion was required to match every retail price promotion. This respondent believed that OAOs were pricing retail services below the wholesale price in order to build market share, and that eircom's retail arm should have the same possibility. The respondent suggested that there was a difference between a very short term limited promotion, and one which was available over a longer time to a broader range of customers. On the question of a rebate, the respondent did not agree that there should be a single rebate payment, and proposed that it was more appropriate to require that the net present value of revenues foregone at the retail level was the same as the wholesale promotion.

ComReg's position

Having considered the responses to consultation, ComReg remains of the view that if eircom introduces retail promotions, such promotions must be matched at the wholesale level. Having determined the appropriate margin between retail and wholesale prices on the basis of the standard undiscounted tariffs, there would clearly be a margin squeeze if retail promotions were not matched by wholesale equivalents. ComReg believes the value of the wholesale rebate should be computed by assessing the revenue foregone at the retail level between the promoted price and the standard price.

One respondent suggested that OAOs are setting retail prices below wholesale costs in order to build market share, and that eircom retail ought to be allowed to do the same. ComReg does not agree with this suggestion. The purpose of this price control is to prevent eircom, as a vertically integrated operator with SMP at the wholesale level, from leveraging its market power into the retail market by means of a margin squeeze. Allowing eircom to supply OAOs at a wholesale price greater than its retail arm was supplying end customers would completely undermine the purpose of the control.

This respondent also suggested that that the wholesale rebate need not be a single payment as proposed by ComReg in the consultation. Having considered this issue, ComReg agrees that so long as the rebate is paid within reasonable period of time, and the net present value of the wholesale rebate is equal to the revenue foregone at retail level, then rebates could be paid in two or more instalments.

Two respondents raised concerns around the issue of retail incentives used by eircom retail such as the inclusion of free gifts and the use of commission payments. ComReg believes that these retail incentives should be outside the scope of the price control. The average cost of customer acquisition used in the margin squeeze analysis underpinning this price control has already factored in the costs of these activities. While ComReg believes that these retail activities are outside the scope of this control, it is clear that eircom could potentially exploit this freedom to create a margin squeeze. Therefore, ComReg will closely monitor eircom's retail activities and will investigate if it believes that a margin squeeze may be occurring. If, upon investigating ComReg concluded that eircom's retail activities were inconsistent with the cost assumptions made in the margin squeeze analysis, then ComReg would direct eircom to pay a wholesale rebate to OAOs.

ComReg remains of the view that where eircom amends or introduces promotions around existing products, then eircom should follow the compliance procedure set out in response to Q14 for the amendment of existing products. That is eircom shall issue ComReg with a statement of compliance and simultaneously notify OAOs of the imminent amendment of wholesale terms and conditions. Where eircom offer two or more promotions at the retail level supported by a single wholesale product, compliance would assessed on the basis of the expected weighted average impact of the relevant promotions.

Decision No. 19.	**See control in Appendix B.**

3.2.20 Other price controls – service establishment, cessation charge and bitstream connection service

Consultation issue leading to Q20

ComReg proposed that a range of other bitstream related wholesale charges and services were not so amenable to a retail minus control, mainly because they did not have direct retail equivalents. The proposed approach to controlling prices for each of these additional services is as follows:

- eircom currently sets a **service establishment charge** of €8,035 per Access Seeker and aims to recover eircom's costs in providing authorisation and training in bitstream IT systems for Access Seeker staff. ComReg proposed that eircom make no increase in this charge, or changes to other terms or conditions, without prior approval from ComReg. ComReg would expect to give approval where there is an appropriate cost-based justification. This charge would be reviewed at the beginning of each new price control period.
- eircom currently sets a wholesale **cessation charge** of €60 per port. This charge does not apply to Access Seekers who agree to amendment of their contracts to reflect a minimum 6 month term for each bitstream subscriber port. ComReg proposed that eircom should make no increase in this charge, or changes to other terms or conditions, without prior approval from ComReg. ComReg would expect to give approval where there is an appropriate cost-based justification.
- ComReg stated in the previous consultation that it believed that the prices for the **bitstream connection services** should be based on FL-LRIC costs. However, ComReg has reconsidered this position in light of the constructive engagement between eircom and access seekers in developing new backhaul products. Therefore, ComReg proposed that it would be appropriate to forbear from imposing specific obligations on these services other than that access to these services should be at reasonable prices.

Q. 20. Do you believe that this [cost justification for service establishment and cessation charges and reasonable prices for bitstream connection service] is an appropriate way of treating the service establishment charge, cessation charge and bitstream connection service?

Views of respondents

Several respondents answered this question in some detail, and a range of views was expressed. One respondent agreed with the proposed approach to the service establishment and cessation charges, but proposed that the cessation approach should be built into the margin test as an input cost. This respondent expressed a view that cost based pricing for connection services could act as a barrier to market growth, and proposed that part of the cost based charge should be included in the rentals.

A second respondent broadly agreed with ComReg's proposal, and noted that treatment of OAOs should be non-discriminatory, in that for these charges which applied to OAOs and eircom's retail arm, there should be equivalence of treatment.

Another respondent agreed with the proposal for the service establishment charge. On the cessation charge, this respondent proposed that ComReg should require eircom to bring this charge into line with its retail practices, and to use the same formula as defined for the connection charge where the cessation charge applies to a port over 6 months in service. The respondent suggested that for ports under six months in service, ComReg should impose a maximum charge of €60 on the penalty rental. In the respondent's view, this would discourage superfluous signups, and would reflect the fact that this wholesale charge is given away free at the retail level. As for the connection charge, this respondent felt strongly that it was not adequate to propose an approach based on reasonable prices.

ComReg's position

Having considered the responses, ComReg remains of the view that these wholesale charges do not have direct retail equivalents and are therefore unsuitable inputs to a retail minus price control.

One respondent proposed that the cessation fee be included in the computation of the margin. ComReg does not believe that this is appropriate as the cessation fee is only payable by operators who refuse to accept a six month minimum contract for each line. ComReg has taken account of the costs associated with the minimum contract terms. ComReg has addressed the issue of the connection fee in its response to Q16.

Another respondent proposed that the maximum rental charge for lines ceased within six months should be capped at the cessation fee of €60. ComReg believes that the current arrangements, where eircom offer two contractual alternatives - one requiring a commitment to a six month minimum term but no cessation fee, the other requiring no commitment to minimum term but requiring a cessation fee - are reasonable and amending this would be inappropriate. ComReg notes this respondent's concerns about the price of the bitstream connection service, and acknowledges that this is a significant cost for very small operators. However, as an operator's volumes grow the proportionate impact of this charge falls significantly. Furthermore, over time new products, more tailored to individual operator's requirements, will be developed and ComReg believes that reasonable prices should be achievable through commercial negotiation. Should this not happen ComReg would intervene to ensure that prices are reasonable.

The service establishment charge will be reviewed at the commencement of each new price control period. In addition, a change in price or terms and conditions for the service establishment charge or the cessation charge requires prior approval from

ComReg. In order to grant such approval, ComReg requires that eircom submit a cost based justification.

As stated in the consultation, the prices for bitstream connection services will not have specific obligations other than that access should be at reasonable prices.

Decision No. 20. The current arrangements, where eircom offer two contractual alternatives - one requiring a commitment to a six month minimum term but no cessation fee, the other requiring no commitment to minimum term but requiring a cessation fee - are reasonable and amending this would be inappropriate. Over time new products, more tailored to individual operators' requirements, will be developed and reasonable prices should be achievable through commercial negotiation. Should this not happen ComReg would intervene to ensure that prices are reasonable.

Decision No. 21. The service establishment charge will be reviewed at the commencement of each new price control period. In addition, a change in price or terms and conditions for the service establishment charge or the cessation charge requires prior approval from ComReg. In order to grant such approval, ComReg requires that eircom submit a cost based justification.

Decision No. 22. The prices for bitstream connection services will not have specific obligations other than that access should be at reasonable prices.

3.2.21 Publication / notification to the wholesale market

Consultation issue leading to Q21

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

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

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

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

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

Views of respondents

Three respondents agreed with the proposal insofar as changes were restricted to prices, but believed that 15 days' notice was not sufficient if changes included product changes. One of these respondents extended this concern to include changes to pricing structure. Another suggested that changes needed to be notified to a wider population than current service operators, and should include, for example, prospective market entrants.

Two respondents indicated that the notice period was too short, and proposed notice periods ranging from 20 days to 45 days.

One respondent expressed a view that the effect of introducing any period between the notification and implementation of price changes was to stall the market.

ComReg's position

ComReg is concerned to balance the need to give OAOs sufficient time to respond to changes of wholesale prices with the need to avoid creating unnecessary impediments on eircom's flexibility. ComReg does not agree that, given the current state of the market, it is appropriate to remove advance notification, and notes that it is supported in this view by all but one of the respondents.

ComReg recognises the concerns expressed by respondents about the desirable length of advance notification, and emphasises that this consultation is restricted to considering changes to price. On that basis, ComReg maintains that 15 working days balances the requirements of all operators. This requirement relates solely to the price control. In decision notice 05/11r, ComReg imposed obligations relating to access and non discrimination. Where eircom introduces new wholesale products, eircom may have to notify OAOs of other non-price related aspects of these new products significantly further in advance in order to be in compliance with all its obligations.

ComReg notes the point that wholesale price changes may be of interest to a wider community than eircom and current OAOs. It is ComReg's intention that wholesale prices will continue to be publicly available on eircom's website. However, the purpose of providing advance notification of these changes is to allow OAOs to respond in their retail offerings, and this can only impact on current OAOs. Therefore, while wholesale prices will be publicly available, advance notice of changes to these prices will not be.

Decision No. 23.	**See control in Appendix B.**

4 Regulatory Impact Assessment ('RIA')

Consultation issue

In the consultation, ComReg examined the impact of elements of the retail minus price control on affected parties.

It was noted that the regulatory impact of imposing a retail minus price control had been examined and consulted on as part of the process of reviewing the WBA market, and was therefore outside the scope of this current consultation. The focus at this stage was on the relative impacts of the different choices relating to the implementation of the retail minus control.

ComReg identified the core regulatory issues as follows:

1. The control is in the form of an ex ante retail minus formula.
2. The margin squeeze test will be reassessed annually to ensure that the assumptions made in the DCF analysis are accurate, and that the coefficients of the formula are amended if necessary.
3. Each wholesale product will have an individual price control formula
4. Where eircom wish to introduce a new retail product it will be required to submit a proposal to ComReg for an assessment of a margin test prior to notifying OAOs of the impending wholesale change.
5. Before implementing any wholesale price changes, including allowing eircom retail to avail of the product, eircom must notify OAOs 15 working days in advance. This notification should be restricted to those OAOs with bitstream contracts and should not be publicly available.

For each core regulatory issue, ComReg outlined alternative proposals, and examined their likely impact on eircom, OAOs and consumers.

Views of respondents

ComReg received one direct response in relation to its RIA. This respondent was generally positive about the need for regulatory intervention in the WBA market. However, it raised concerns around what it interpreted as ComReg's tampering with variables in the WBA market to improve the impact of regulatory intervention in the LLU market.

ComReg's position

ComReg believes that enhancing competition in the WBA market will be of benefit to all competitors. It was not ComReg's intention to infer that intervention in one market would be used to address problems identified in another. However, ComReg does believe that longer term benefits to do with lowering costs and enhancing innovation will best be achieved with a price control which does not limit incentives to invest in infrastructure.

In relation to the 5 core regulatory implications identified, ComReg has concluded the following:

1. **The control is in the form of an ex ante retail minus formula.** ComReg believes that the benefits to OAOs and consumers of using an ex ante approach justify the greater regulatory impact upon eircom compared to using an ex post approach for the reasons set out in consultation 05/67 and in Section 3.2.1 in this document.
2. **The margin squeeze test will be reassessed annually to ensure that the assumptions made in the DCF analysis are accurate, and that the coefficients of the formula are amended if necessary**. ComReg believes that the benefits to OAOs and potentially eircom of reassessing the margin squeeze test annually to ensure that the assumptions made in the DCF analysis are accurate justifies the greater regulatory impact upon eircom compared to less frequent reassessments.
3. **Each wholesale product will have an individual price control formula**. ComReg believes that the benefits to OAOs and consumers of each wholesale product having an individual price control formula justifies the greater regulatory impact upon eircom compared to the portfolio approach. This will promote competition for all products to the benefit of consumers.
4. **Where eircom wish to introduce a new retail product it will be required to submit a proposal to ComReg for an assessment of a margin test prior to notifying OAOs of the impending wholesale change**. ComReg believes that the benefits to OAOs and consumers of assessing the compliance of new products in advance of wholesale notification justifies the greater regulatory impact upon eircom compared to a statement of compliance for new products with simultaneous wholesale notification. This will reduce the risk of foreclosure and promote competition to the benefit of consumers.
5. **Before implementing any wholesale price changes, including allowing eircom retail to avail of the product, eircom must notify OAOs 15 working days in advance. This notification should be restricted to those OAOs with bitstream contracts and should not be publicly available**. ComReg believes that the benefits to OAOs and consumers of an advance notification period of 15 working days prior to the implementation of any wholesale price changes justifies the greater regulatory impact upon eircom compared to no notification period. ComReg believes that a period greater than 15 days would be disproportionate and burdensome on eircom and would negatively affect consumers by unnecessarily delaying innovation.

Appendix A – List of Draft Directions and Decisions

List of Draft Directions and Decisions

Appendix B – Draft Control Mechanism

STATUTORY POWERS GIVING RISE TO THIS DECISION INSTRUMENT

1.1 This decision instrument relates to the market for wholesale broadband access ("WBA") for the purpose of delivering broadband content to end users[14] and is made by the Commission for Communications Regulation ("ComReg"):

I. Having had regard to sections 10 and 12 of the Communications Regulations Act 2002;

II. Having taken account, of its functions under Regulation 6 (1) of the European Communities (Electronic Communications Networks and Services) (Access) Regulations 2003[15];

III. Having (where appropriate) complied with the Policy Directions made by the Minister[16];

IV. Having taken the utmost account of the EU Commission's Recommendation[17] and the Guidelines[18];

V. Having had regard to the market definition, market analysis and reasoning conducted by ComReg in decision 03/05[19], the analysis and reasoning set out

---

[14] As referred to in the EU Commission's Recommendation.

[15] S.I. No. 305 of 2003 the European Communities (Electronic Communications Networks and Services) (Access) Regulations 2003 which transposes Directive 2002/19/EC of the European Parliament and the Council of 7 March 2002 on access to, and interconnection of, electronic communications networks and associated facilities.

[16] Policy Directions made by Dermot Ahern T.D. (the then) Minister for Communications, Marine and Natural Resources on 21 February 2003 and 26 March 2004.

[17] EU Commission Recommendation of 11 February, 2003 on Relevant Product and Service Markets within the electronic communications sector susceptible to ex ante regulation in accordance with Directive 2002/21/EC of the European Parliament and the Council of 7 March 2002 on a common regulatory framework for electronic communications networks and services.

[18] Commission Guidelines on market analysis and the assessment of significant market power under the Community regulatory framework for electronic communications networks and services.

[19] *Designation of SMP and Related Remedies – Market Analysis – Wholesale Broadband Access* dated 24 February, 2005.

in document No. 05/67[20] and the reasoning and individual decisions set out previously in this document, each of which form part of and shall be construed with this decision instrument;

VI. Having taken account of the submissions received in relation to document No. 05/67; and

VII. Pursuant to Regulations 27 (4) of the European Communities (Electronic Communications Networks and Services) (Framework) Regulations 2003[21], Regulations 9 and 14 of the European Communities (Electronic Communications Networks and Services) (Access) Regulations 2003.

2 DEFINITIONS

2.1 In this decision instrument, unless the context otherwise suggests:

"Access Regulations" means the European Communities (Electronic Communications Networks and Services) (Access) Regulations 2003;

"amendment" means, in respect of a tariff for any existing product, a change, adjustment, modification and any other cognate word or expression;

"bundle" means a package, consisting of both a product and one or more goods and / or services, which is on offer or sale to end users;

"decision instrument" means this decision instrument;

"discount" means an offer or sale of a product at less than its standard price. Examples shall include: a price reduction (including a volume related price reduction) a rebate, a reimbursement, a refund, set-off and any other cognate words or expressions;

"end user" has the same meaning as in Regulation 2 (1) of the European Communities (Electronic Communications Networks and Services) (Framework) Regulations 2003);

"existing product" means any product on offer or on sale to end users on or prior to the effective date of this decision instrument and any new product that ComReg has decided complies with the obligations referred to in this decision instrument;

[20] *Consultation Paper - Consultation on retail minus wholesale control for the WBA market* dated 19 August, 2005.

[21] S.I. No. 307 of 2003 the European Communities (Electronic Communications Networks and Services) (Framework) Regulations 2003 which transposes Directive 2002/21/EC of the European Parliament and the Council of 7 March 2002 on a common regulatory framework for electronic communications networks and services.

"new product" means any product on offer or sale subsequent to the effective date of this decision instrument which has different functional and / or technical characteristics and / or a different tariff structure to existing products;

"product" means any *eircom* retail broadband product on offer or sale to end users which uses *eircom's* copper network equipment to transmit data signals and shall include existing products and new products;

"OAO" means other authorised operator, being an authorised undertaking for the purposes of the European Communities (Electronic Communications Networks and Services) (Authorisation) Regulations 2003;

"promotion" means an offer in respect of a product which is available for a finite period of time that offers a tariff reduction but does not include incentives provided for within normal sales costs;

"SMP" has the same meaning as set out in Regulation 25 of the European Communities (Electronic Communications Networks and Services) (Framework) Regulations 2003; and

"working day" means a day other than Saturday, Sunday a bank holiday or a public holiday.

3 SMP OBLIGATIONS IN FORCE

3.1 By virtue of the decision 03/05 *eircom* had imposed upon it the SMP obligations of access, non-discrimination, transparency, price control and cost accounting.

3.2 *eircom* notified an appeal to the Electronic Communications Appeals Panel ("the ECAP") on 16 March, 2005 in respect of the price control SMP obligation. On the 24 June, 2005 the Minister for Communications, Marine and Natural resources appointed the ECAP to hear the notified appeal.

3.3 The other SMP obligations contained in decision 03/05 are not the subject of any appeal by any OAO, or suspension order by the ECAP. Accordingly, they remain in force in their entirety and shall where necessary, be construed together with this decision instrument.

4 PRICE CONTROL OBLIGATION: GENERAL

4.1 *eircom* shall, pursuant to Regulation 14 of the Access Regulations, have obligations relating to wholesale price control in the market for WBA, in the form of a retail minus price control, for the following purposes:

I. Establishing a wholesale price for products, promotions, discounts and bundles in the market for WBA;

II. Preventing the potential application by *eircom* of a price or margin squeeze in the market for WBA. In this regard, *eircom shall* not create a margin squeeze in the market for WBA ; and

III. Preventing *eircom* from sustaining prices at an excessively high level in the market for WBA.

5 AMENDMENTS TO EXISTING PRODUCTS

5.1 Sections 5.2 – 5.6 apply to any amendment.

5.2 In this section, "retail rental price" means the retail price where a single product is supported by a single wholesale offering or, the weighted average (by number of subscribers) of the retail products' individual prices where more than one product is supported by a single wholesale offering. The retail minus price control applying to existing products shall be established by reference to the following formula**:**

*Wholesale Rental Price = retail rental price * (1 - fixed percentage < 100%) - fixed monetary value* ("the price control")[22].

5.3 *eircom* shall ensure that it applies the price control to the equivalent wholesale offering of any existing product. Amendments shall be in accordance with the price control and as specified in Table 1 below. Table 1 may from time to time be amended by ComReg for any of the following reasons:

I. When an equivalent wholesale offering of any new product is introduced;

II. When ComReg conducts a review of the price control; or

III. If ComReg decides to amend the price control or the obligations referred to in this decision instrument as a result of any material unforeseen changes in market conditions that in ComReg's opinion have a material impact on the market.

[22] The following is an example, for illustrative purposes, of an application of the price control in practice: if the retail price for the "1024/128 @ 48:1 (IP)" product was to be €50, the wholesale price could be no more than €50 * (1-29%) - €4.37 = €31.13.

Table 1

Wholesale Product	Control	
Description[23]	Percentage (%)	Fixed Monetary Value (€)
1024/128 @ 48:1 (IP) plus usage charge[24]	30%	€3.70
1024/128 @ 48:1 (IP)	29%	€4.37
2048/256 @ 24:1 (IP)	28%	€4.70
3072/256 @ 24:1 (IP)	26%	€6.75
4096/256 @ 24:1 (IP)	24%	€12.64

5.4 No later than fifteen working days prior to the date that an amendment is to become operative, *eircom* shall furnish to ComReg a detailed written statement of compliance demonstrating *eircom's* compliance with the price control and the obligations referred to in this decision instrument**.** The statement of compliance shall make full and true disclosure of all material facts for the purpose of demonstrating compliance with the price control and the obligations referred to in this decision instrument and shall state precisely and in all respects how *eircom* is in compliance with the price control and the obligations referred to in this decision instrument. The statement of compliance shall also have appended to it, all relevant supporting documentation for the purpose of demonstrating compliance with the price control and the obligations referred to in this decision instrument. The statement of compliance shall demonstrate how any adjustments to the price of the equivalent wholesale offering of an existing product are and will be in compliance with the price control and the obligations referred to in this decision instrument.

[23] The following is an explanatory note and does not form part of the decision instrument that is being notified to the EU Commission: should *eircom* amend the technical characteristics of the wholesale products between the date that the decision instrument is notified to the EU Commission and the adoption of this decision instrument, Table 1 will be updated accordingly.

[24] Where usage charges make up a significant portion of retail or wholesale prices, these charges will be converted into average monthly revenues and the price control will be applied accordingly.

5.5 At the same time that *eircom* furnishes the statement of compliance referred to in section 5.4 to ComReg, it shall furnish all OAOs availing of or intending to avail of existing products, with written notification of corresponding adjustments to an equivalent wholesale offering of any existing product. *eircom* shall furnish ComReg with a copy of the notification and written confirmation that all OAOs have been furnished with the notification.

5.6 Upon receipt of the statement of compliance and the notification referred to in sections 5.4 and 5.5 respectively, ComReg shall review the statement of compliance. Within the fifteen working day period referred to in section 5.4 ComReg may do one or more of the following things:

I. Provide *eircom* with both (a) an appropriate written opinion in relation to the statement of compliance referred to in section 5.4 and (b) written confirmation that the making available or offering for sale of the existing product is conditional only upon *eircom* being in compliance with its obligation in section 5.3. Once ComReg provides *eircom* with the written opinion and confirmation referred to in this sub-section;

II. Request any further information from *eircom*. *eircom* shall provide the requested information by the deadline and in such format and to the level of detail as stipulated by ComReg. Upon receipt of the requested information from *eircom* and within the fifteen working day period referred to in section 5.4, ComReg may do one or more of the things referred to in sub-sections I, III or IV of this section;

III. Inform *eircom* in writing that the amendment(s) would in ComReg's view, not be in compliance with the price control and the obligations referred to in this decision instrument, giving reasons therefor and also inform *eircom* that the amendment if made operative will or could result in the issuing of a notification of non-compliance under Regulation 18 (1) of the Access Regulations; or

IV. For the purpose of further specifying requirements to be complied with by *eircom* relating to the price control and the obligations referred to in this decision instrument, issue a direction or directions to *eircom* under Regulation 17 of the Access Regulations, to refrain from making operative the corresponding adjustment(s) to the equivalent wholesale offering of any existing product.

6 NEW PRODUCTS

6.1 Sections 6.2 – 6.5 apply to any new product.

6.2 *eircom* shall not make available or offer for sale, the equivalent wholesale offering of any new product, until such time as ComReg does that which is specified in section 6.5, sub-section I (either within the five working day period referred to in section 6.5 or, upon completion of the analysis by ComReg referred to in section 6.5, sub-section II).

6.3 *eircom* shall apply the price control to the equivalent wholesale offering of any new product.

6.4 Prior to the date that a new product is to be made available or offered for sale, *eircom* shall furnish to ComReg a detailed written submission demonstrating *eircom's* proposed compliance with the price control and the obligations referred to in this decision instrument. The submission shall make full and true disclosure of all material facts for the purpose of demonstrating proposed compliance with the price control and the obligations referred to in this decision instrument and shall state precisely and in all respects how *eircom* would be in compliance with the price control and the obligations referred to in this decision instrument. The submission referred to in this section, shall also have appended to it, all relevant supporting documentation for the purpose of demonstrating proposed compliance with the price control and the obligations referred to in this decision instrument. The submission shall demonstrate how any adjustments to the price of the equivalent wholesale offering of a new product would be in compliance with the price control and the obligations referred to in this decision instrument.

6.5 Upon receipt of the submission referred to in section 6.4, ComReg shall review same. Within five working days, ComReg may do one or more of the following things:

I. Provide *eircom* with both (a) an appropriate written opinion in relation to the submission referred to in section 6.4 and (b) written confirmation that the making available or offering for sale of the new product is conditional only upon *eircom* being in compliance with its obligation in section 6.3. Once ComReg provides *eircom* with the written opinion and confirmation referred to in this sub-section, *eircom* shall provide OAOs that are availing of any existing products (or intending to avail of any existing products) with fifteen working days' prior written notification of corresponding adjustments to the equivalent wholesale offerings of any new products before making such adjustments. *eircom* shall at the same time furnish ComReg with written confirmation that all OAOs have been furnished with the said notification;

II. Inform *eircom* in writing that further analysis of the submission referred to in section 6.4 is required by ComReg, in which case ComReg may request any further information from *eircom. eircom* shall provide any information that is requested by the deadline, in such format and to the level of detail as stipulated by ComReg. Upon receipt of the requested information, ComReg shall furnish *eircom* with an indicative timetable in writing for the completion of its further analysis. Upon completion of this analysis, ComReg may do one or more of the things referred to in sub-sections I, III, IV or V of this section;

III. Inform *eircom* in writing that the new product(s) would in ComReg's view, not be in compliance with the price control and the obligations referred to in this decision instrument, giving reasons therefor and also inform *eircom* that the new product(s) if made available or offered for sale, will or could result in the issuing of a notification of non-compliance under Regulation 18 (1) of the Access Regulations;

IV. For the purpose of further specifying requirements to be complied with by *eircom* relating to the price control and the obligations referred to in this decision instrument, issue a direction or directions to *eircom* under Regulation 17 of the Access Regulations, requiring that *eircom* makes specified corresponding adjustments to the price of the equivalent wholesale offering of any new product; or

V. For the purpose of further specifying requirements to be complied with by *eircom* relating to the price control and the obligations referred to in this decision instrument, issue a direction or directions to *eircom* under Regulation 17 of the Access Regulations, to refrain from making available or offering for sale, the equivalent wholesale offering of any new product.

7 PROMOTIONS

7.1 Sections 5.2 – 5.6 (excluding Table 1) in relation to amendments to existing products shall apply in like manner to promotions.

8 DISCOUNTS AND BUNDLES

8.1 Sections 6.2 – 6.5 in relation to new products shall apply in like manner to discounts and bundles and shall apply to an adjustment to a discount or bundle available, or on sale, on or prior to the effective date of this decision instrument and to a new discount or bundle that is made available or offered for sale after the effective date of this decision instrument.

9 STATUTORY POWERS NOT AFFECTED

9.1 Nothing in this decision instrument shall operate to limit ComReg in the exercise and performance of its statutory powers or duties under any primary or secondary legislation (in force prior to or after the effective date of this decision instrument) from time to time as the occasion requires.

10 EFFECTIVE DATE

10.1 This decision instrument shall be effective from the **[●]** day of **[●]** 2005 until further notice by ComReg.

ISOLDE GOGGIN
CHAIRPERSON
THE COMMISSION FOR COMMUNICATIONS REGULATION
THE [●] DAY OF [●] 2005

Appendix C - The Broadband 'New Entrant' Discounted Cash Flow (DCF) Model

The DCF model consists of a set of spreadsheets. The costs are based on those of eircom, in line with the principle set out earlier in the document of a similarly efficient operator and therefore the cost parameters and the model itself are confidential.

The model calculates the margins required between wholesale and retail for individual wholesale products such that a return of 11.5% is achieved.

The product parameters considered in the model are:

- Monthly rental revenue (variable over time)
- Monthly connection revenue (variable over time)
- Upstream bandwidth
- downstream bandwidth
- contention ratio
- delivery technology (IP or ATM)

The model is built on a discounted cash flow basis and includes start up costs, terminal value and fixed and variable operating costs including capital costs.

The costs are categorised under the following headings:

- Marketing
- Sales
- Product management & development
- Accommodation
- Help Desk
- Billing
- Modems
- Order Handling
- Backhaul charges
- Servers and collocation
- Corporate overhead
- Internet connectivity (peering charges)
- Wholesale connection
- Wholesale rental

Revenues are limited to connection charges and rental charges. No value added service revenue is included since the model is limited to an internet connection business.

The model is designed to allow considerable flexibility in setting scenarios. The factors that can be varied include:

- Market size
- Product take-up over time (sales growth curve)
- Product mix
- Customer lifetime
- All costs over both time and volume as appropriate
- Retail revenues, by product, over time

The model provides outputs in the form of retail minus controls of the type (R-X%)-C for each retail product (or product group) based on a single wholesale product. In the formula:

- R is the retail price of the product (where necessary by weighted average price of retail products within the group),
- X% is a percentage reduction on the retail price, and
- C is a constant monetary value reduction on the retail price.

Neither X nor C can be less than zero.