CONSEIL DE LA CONCURRENCE

Mise en consultation par l'ILR du document « Projet de définition d'une méthode ex-ante pour la prévention de ciseaux tarifaires »

AVIS DU CONSEIL DE LA CONCURRENCE

N°2013-AV-02

(01.08.2013)

Le présent avis répond à la demande d'avis de l'Institut Luxembourgeois de Régulation relative au projet de définition d'une méthode ex-ante pour la prévention de ciseaux tarifaires.

Afin de systématiser et homogénéiser le contrôle tarifaire ex-ante des offres de gros, l'ILR veut se doter d'un instrument qui lui permettra de contrôler que les prix pratiqués par une entreprise verticalement intégrée (ou par ses filiales) sont tels qu'ils dégagent une marge suffisante pour permettre aux concurrents d'opérer de manière économiquement viable.

Cette prise de position est sans préjudice de l'avis que le Conseil rendra sur tout projet de mesures que l'ILR envisage de prendre dans le cadre de la régulation des marchés 4 et 5.

Elle se réfère au document mise en consultation publique sous :
http://www.ilr.public.lu/communications_electroniques/avis_consultations/avis_200613/Consultative_Document_Margin_Squeeze.pdf

Question 1:
Do you agree with the definition of a margin squeeze presented here?

The Competition Council (hereafter: the Council) fully agrees with the definition in 2.1.: a vertically integrated firm with market power supplies rivals in the downstream market at wholesale prices in a way that those rivals cannot profitably compete at prevailing retail prices.

We also share the view that non-discriminatory obligations such as "Equivalence of Input" (2.4) do not exclude by themselves the possibility of a margin squeeze or even predation by the vertically integrated SMP operator. The same is true for regulated cost-oriented access prices, as cost orientation might be difficult to assess.

We strongly support the idea that the retail margin, i.e. the margin between wholesale and retail prices, must include an appropriate profit margin covering the cost of capital.

However, we do not understand what is meant with "direct margins" (2.8.).
Also, we do not understand why the "reference standard" for a margin squeeze test is a retail market with effective competition. (2.11.) Does this mean a margin squeeze test should be run under the assumption of effective competition, even if these means estimating competitive prices which could differ from actual prices?

We would suggest that a margin squeeze can only be revealed by comparing existing real world retail and wholesale prices.

Question 2:
Do you agree with the analysis of the competitive implications of a margin squeeze?

The Competition Council certainly agrees that "Margin squeezing is a form of anti-competitive behaviour which can lead to foreclosure of competition" (2.9).

Question 3:
Do you support the intended ILR approach of a future application of the margin squeeze remedy?

The Competition Council supports the intention to implement the margin squeeze test as an additional remedy in those markets where wholesale price remedies or non-discriminatory obligations seem appropriate. The Council is aware that pending regulatory changes replace in some cases cost-oriented wholesale price obligations with EoI obligations combined with a financial replicability test. Although these regulatory changes might result in higher end prices, they are not inconsistent with competition law insofar as they continue to promote competition at the retail level.

However, the margin squeeze test should be viewed as a test on wholesale, not retail prices. If a margin squeeze is revealed, regulatory action should focus on wholesale prices, because the SMP operator is unlikely to lower its wholesale prices without regulatory intervention. If there is sufficient evidence that wholesale prices do not exceed costs, than the regulator as well as the competition authority must carefully balance the harm to competition with the benefit to society arising from low retail prices.

Question 4:
Do you consider the application of the margin squeeze test to flagship products as appropriate?

The application of the test to those offers or services that have the biggest impact on the market is certainly appropriate.

However, the council does not understand section 4.4. Applying a test to mixed bundles, which might include services that are not related to markets 4 and 5, while also restricting the test to markets 4 and 5 seems problematic.

We look at the biggest retail flagship product in Luxembourg: a mixed bundle (not a pure bundle) called "Integral" spanning fixed telephony, mobile telephony and broadband services. Would ILR apply the test only to services involving markets 4 and 5, i.e. broadband access, and, in some cases, fixed telephony? Fixed telephony might be based on market 4, or on a Line Rental Offering.

This would mean that the test is applied to part of the flagship product only, but not to the whole product. Since this approach would not account for the possibility of cross-subsidies between the services in the bundle, a margin squeeze might be revealed for some services, but not for the bundle as a whole. This, to our knowledge, is not the standard approach among European regulators or competition authorities. For instance, the European Commission has stated that:

"If the evidence suggests that competitors of the dominant undertaking are selling identical bundles, or could do so in a timely way (...), the Commission will generally regard this as a bundle competing against a bundle, in which case the relevant question is not whether the incremental revenue covers the incremental costs for each product in the bundle, but rather whether the price of the bundle as a whole is predatory." (Guidance on the Commission's enforcement priorities in applying Article 82 of the EC Treaty to abusive exclusionary conduct by dominant undertakings, 2009/C45/02 pt. 61)

For example, in the bundle mentioned above, fixed telephony services are mostly free of charge for the final client, but not for the operators. This service must obviously be subsidized by other services in the bundle.

Question 5:
Do you agree with the proposed definition of a flagship product or do you have suggestions for a modification of the definition?

The Council does not object to that definition.

Question 6:
Do you agree with the conceptual margin squeeze test approach of ILR?

The Equally Efficient Operator test is the most widely used by competition authorities and jurisdictions and was used in the most influential competition law cases. The Council does not think that regulators must use different models than competition authorities.

Since the retail revenues and the wholesale costs should be the same for EEO and REO, the difference can only lie in downstream costs, insofar as EEO does not allow for downstream cost efficiencies. Is there empirical evidence showing significant economies of scale or scope in downstream costs, justifying a different downstream cost estimate for alternative operators than for SMPs? Also, how can ILR be sure that a difference in costs is due to economies of scale rather than inefficiencies?

The Council understands that ILR considers that downstream costs do not include only retail costs (12.1). But, in the case of low value added resale services, as those provided by an operator working with wholesale line rental and bitstream access, downstream costs are essentially retail costs. Here, economies of scale seem rather unlikely.

On the other hand, the big inconvenience of EEO, but also, as we understand, of REO and SEO, is that the SMP operator has to provide an estimate of its own downstream costs, which might be credible or not. A better solution would be ILR estimating downstream costs using an appropriate cost model of its own.

However, an REO or SEO test places the hurdle for the SMP operator higher than an EEO test, and therefore must not be viewed as inconsistent with competition law.

Question 7:
Do you support the choice of the most relevant business model in Luxembourg?

The Council supports this choice.

Question 8:
Do you agree with applying LRIC+ as the cost standard for downstream cost?

With regards to LRIC: the Council does not understand the difference between "the whole output of the product" and "the incremental output associated with the activity" (7.1). This sounds confusing.

Competition authorities and jurisdictions and some high-profile ECJ judgments (Deutsche Telecom, Telefonica) refer to Long Run Average Incremental Costs. The EC defines these in its recommendation 2009/C45/02 as follows:

"*LRAIC and average total cost (ATC) are good proxies for each other, and are the same in the case of single product undertakings. If multi-product undertakings have economies of scope, LRAIC would be below ATC for each individual product, as true common costs are not taken into account in LRAIC. In the case of multiple products, any costs that could have been avoided by not producing a particular product or range are not considered to be common costs.*"

Admittedly, the EC also writes that "*in situations where common costs are significant, they may have to be taken into account when assessing the ability to foreclose equally efficient competitors*", but this sounds quite inconsistent.

To the Council's understanding, LRIC or LRAIC are the costs caused by one service, closely related to avoidable costs. E.g. for broadband access: which costs would be avoided if broadband access were not offered? Thus LRIC includes specific fixed costs, but no common costs.

One might fear that excluding common cost from the estimation of downstream costs might disadvantage those operators that have not a broad client or product base over which to distribute the common cost. This disadvantage would be mitigated by also excluding common costs from the wholesale cost model, if applied.

The allocation of common costs is always debatable and often contentious. Therefore, they should be excluded from cost calculations whenever possible. We are aware however that the new regulatory approach promoted by the EC favours LRIC+.

Question 9:
Which WACC do you consider conceptually as appropriate in the margin squeeze context and which value for the WACC do you suggest?

The council agrees with the description of WACC in 8.1.
The standard model for estimating WACC is:

$WACC = (Debt* r_{debt}+Equity*r_{equity})/(Debt+Equity)$
Whereby: Equity = own funds;
r_{debt} = cost of debt;
r_{equity} = cost of own funds.

r_{debt} should be estimated from company data, r_{equity} has typically been estimated with the Capital Asset Pricing Model:

r_{equity} = Risk free rate + Risk Premium.
The company-specific risk premium could be estimated using financial market data.

Since WACC must be estimated on the basis of the relevant economy- and company-specific data, the Council is not able to provide a number out of the blue.

One should note that the WACC is related to the retail service, but the capital required must also finance the wholesale costs.

Question 10:
Do you agree with ILR's concept of relevant regulated wholesale inputs to be used for the margin squeeze test?

The Council agrees.

Question 11:
Do you agree with the approach of dealing with retail prices in the context of the margin squeeze test?

The Council understands section 10 as follows: revenues are calculated using retail prices and parameters which quantify consumer behaviour and usage. Consumer behaviour is based on a single national average which is the same for each product and each operator. Discounts, rebates and give-aways must be taken into account. If this is the choice of ILR, the Council agrees.

Question 12:
Do you support the steady state approach ILR intends to use in conducting the margin squeeze test?

The view of the Council is that the choice of the period and time frame should not alter the test results. If two testing methods are equally valid, then the one that needs the least parameters and assumptions should be chosen. Obviously, accounting distortions should be avoided.

Question 13:
Do you agree that the identification of retail costs on the basis of a global mark-up is the appropriate approach?

As explained under Question 8, competition authorities would not allow for common costs being part of downstream costs. Common costs would exist even if an operator would not provide a given service, and there is no undisputed way to allocate common costs over different services or products.

ILR should explain what is meant by the global mark-up (12.5), and how it is calculated or estimated. What is the economic rationale?

As mentioned under question 6, the Council suggests to ILR to use a proprietary cost model for estimating downstream costs.

Question 14:
In case you prefer the category-by-category approach would your cost accounting system be prepared to provide reliable data on each cost category?

Question 15:
Are all relevant cost categories covered in para. 12.2 and 12.4? In case a relevant cost category is missing, please specify.

The Council has no comment on Questions 14 and 15.

Question 16:
Do you agree with the procedural rules of applying the margin squeeze test or do you have suggestions for different rules?

This section seems to imply that the SMP operator will have to conduct the test himself. This raises the question whether ILR will set up the test or will merely provide the guidelines outlined in the consultation paper?

The Council thinks that the test should be set up and run by the regulator. Otherwise the regulator as well as the whole industry will still have to rely on the SMP for the relevant

parameters, cost estimates, and calculus details, even if some of the parameters would be provided by ILR.

Wouldn't this approach also mean that the SMP operator would have to estimate the downstream costs of the alternative operators (cf. 5.6)?

Question 17:
Do you agree with the described consequences of an identified margin squeeze or do you have suggestions for different rules?

Question 18:
Do you support the approach of conducting periodical ex post margin squeeze tests instead of conducting an ex ante test each time a relevant retail price changes?

The Council does not understand the procedure outlined in 14.3. If the margin squeeze test reveals a negative margin, the wholesale tariff cannot be approved by the regulator. If the wholesale tariff has already been approved, shouldn't approval be withdrawn? If the margin squeeze test involves a wholesale input whose tariff is not regulated, couldn't ILR consider the possibility to re-impose wholesale tariff regulation?

Question 19:
Do you have any general remark about the proposed approach?

The comments of the Competition Council are aimed at assessing whether the proposed changes by ILR are consistent with EU competition law and the purpose of competition policy in general. These comments are without prejudice to the opinion the Competition Council will express on the remedies ILR intends to impose in markets 4 and 5.

The margin squeeze test is widely used by competition authorities and jurisdictions, and the Council supports its use by ILR. The REO and SEO tests as well as the LRIC+ cost model are not common practice in competition enforcement, but are not inconsistent with competition law. The LRIC+ method seems to be favoured in the new EU-wide regulatory framework.

From the point of view of competition policy, regulation should, whenever possible, favour measures that tend to lower wholesale access tariffs rather than raise retail prices, with a view to maximize consumer welfare.