Guidelines on assessment of margin squeeze

Version 2.0

11 October 2017

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1. Introduction

1.1 Overview

This is the second version of the Guidelines, with only minor typographical amendments made from the 2015 version, to reflect the fact that Manx Telecom has now completed and published its first set of separated accounts.

A margin squeeze arises when a dominant operator, which provides a wholesale input on which other operators rely in order to compete at the retail level, prices its upstream (wholesale) services and downstream (retail) services in such a way as to prevent others from competing with it at the downstream level.

In its Decision[1], having designated Manx Telecom ("MT") with SMP in the wholesale fixed markets the Communications Commission ("CC") imposed a price control obligation on MT in accordance with Condition 44.2.1 of MT's licence, such that MT is directed not to cause a margin/price squeeze.

The purpose of this document is to set out guidance for operators on how the CC expects the obligation not to cause a margin squeeze to be implemented. The document sets out the general methodology which will apply, and sets out the broad parameters which the CC will consider.

It is noted that the guidance set out in this document relates to the *ex ante* obligation put in place following an SMP designation, and is entirely without prejudice to the application of competition rules which may apply in any *ex post* consideration of alleged margin squeeze.

1.2 Background

Recent guidance from the European Commission[2] and from BEREC[3] sets out the parameters for performing an Economic Replicability Test (ERT), which is a concept BEREC suggests differentiates the proposed ex ante margin squeeze test from the form of test generally used under ex post (competition law) procedures. We have taken this guidance to regulators into account, and believe that the concept of ERT encapsulates the aim of assessing margin squeeze as an *ex ante* SMP obligation. The ERT assesses whether the margin between the retail price of the relevant retail products and the price

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[1] Notification of market power determination: wholesale fixed markets, Decision Notice 2012/02

[2] COMMISSION RECOMMENDATION of 11.9.2013 on consistent non-discrimination obligations and costing methodologies to promote competition and enhance the broadband investment environment, C(2013) 5761 final

[3] BEREC Guidance on the regulatory accounting approach to the economic replicability test (i.e. *ex-ante*/sector specific margin squeeze tests), BoR (14) 123

of the relevant regulated wholesale access inputs covers the incremental downstream costs and a reasonable percentage of common costs. A lack of economic replicability exists if the SMP-operator's downstream retail arm could not trade profitably on the basis of the upstream price charged to its competitors.

There are two broad types of test. The first test is whether the incumbent's own downstream operation would be profitable if it had to pay the same wholesale charge as its competitors. This approach – seeing whether the vertically integrated firm's downstream arm could operate profitably at the wholesale charges paid by downstream competitors – is known as the "equally-efficient operator" test. That is, it tests whether equally or more efficient downstream competitors would be prevented from competing effectively, using the vertically integrated firm's downstream costs.

The second test is whether a reasonably efficient competitor is able to make a profit. This alternative formulation of the margin squeeze test relates to the costs of a "reasonably efficient" entrant. This test recognizes that the costs of a reasonably efficient entrant could be higher than those of the incumbent, due to the latter's economies of scale and scope.

The equally efficient operator test has the advantage of being more straightforward to apply, in that it is based on the SMP operator's costs and revenues. The reasonably efficient operator test is based on assumptions about potential costs and revenues of an unidentified entrant, and while it may be more reflective of market reality, it is more difficult to apply and more susceptible to error.

We therefore propose to use an equally efficient operator test (which will use MT's retail costs) in the first instance. If the EEO approach proves to be inadequate, we will review this approach.

2. Structure of the test

2.1 Data required for the calculation

The basis for calculating economic replicability is to assess whether an operator could trade profitability given a particular wholesale price, and a particular retail price. The difference between the prices should be sufficient to allow profitable trading, and this is generally taken to mean that the difference between the prices should cover retail costs, some common costs, and a reasonable return.

The calculation of economic replicability therefore requires the following information:

- Identification of relevant retail products
- Identification of wholesale input
- Retail price
- Wholesale input price
- Retail costs
- Measure of profitability

2.2 Relevant retail products

The identification of relevant retail products concerns the aggregation at which the ERT should be applied. It is possible to carry out a margin squeeze analysis across a portfolio of related products, or at the level of individual retail products. A narrow interpretation would require Manx Telecom to show that each individual tariff package did not create a margin squeeze. The benefit of this approach is that it eliminates the possibility of any abuse of dominance. Ensuring that there is no margin squeeze on any retail product should avoid the market entrant having to replicate the incumbent's product mix in order to be viable; new entrants can target specific retail segments, without encountering possible cross-subsidisation by the incumbent from one segment to another, which could make addressing certain segments in isolation unattractive.

There is the danger, however, that this approach might be unduly onerous, since operators cannot predict exactly in advance what their customers' usage of different elements of each package will be in each month, and since the burden of demonstrating compliance would be correspondingly high. A broader interpretation would be to carry out the margin squeeze tests on the defined markets where there has been an SMP finding. However, in this interpretation, "passing" the margin squeeze test, for the operator, would simply amount to demonstrating that its services were profitable overall. In order to compete, it might be necessary for competitors to offer the same full product portfolio as the incumbent. This would not exclude the possibility of dominant operators targeting special tariffs to damage competing operators, and even to eliminate them over time, by squeezing the margin in one product while remaining within the overall balance of the portfolio.

We propose that the ERT should be carried out at the level of the SMP operator's individual retail product. The use of a product-by-product approach ensures that each retail offer is replicable and that there can be no form of cross-subsidy between the retail offers.

We note that this approach is consistent with EU Case Law, and with guidance to regulators provided by the EC and BEREC.

2.3 Identification of wholesale input

The EU advice is that regulators should identify the most relevant regulated inputs used or expected to be used by access seekers – it should be a single level test between the relevant retail product and the most relevant wholesale input(s).

2.4 Retail price

The retail price used in the ERT would be the price of the identified retail product.

It is proposed that temporary discounts and/or promotions should be taken into account, given their competitive effect. Depending on the market, this could be done by directly reflecting the promotion or discounted price in the retail price used in the ERT, or by including promotions and discounts as a cost in the assessment of retail costs.

2.5 Wholesale input price

We propose to use the price of the wholesale product(s) which are most relevant for offering the identified retail products as the wholesale input price. In accordance with Condition 44.2.3 of its Licence, MT is required to maintain appropriate cost accounting systems in respect of the price controls imposed in accordance with Condition 44.2.1 regarding products, services or facilities in the wholesale fixed markets. The output of MT's cost modelling exercise is being used as a basis for setting the prices of wholesale products offered by MT. This is consistent with EU advice[4]:

[4] COMMISSION RECOMMENDATION of 11.9.2013 on consistent non-discrimination obligations and costing methodologies to promote competition and enhance the broadband investment environment, C(2013) 5761 final

When identifying the relevant reference wholesale price, NRAs should consider the access price that the SMP operator effectively charges third-party access seekers for the relevant regulated wholesale input. These wholesale access prices should be equivalent to the prices that the SMP operator charges to its own retail arm.

2.6 Retail costs

Retail costs are defined as specific incremental costs[5] needed to provide the identified product or service on the retail market. As discussed earlier, the costs to be considered for the ERT calculation are MT's retail costs.

Retail cost categories may generally include:

- Customer acquisition and retention
- Customer care/help desk
- Marketing and advertising
- Billing
- Sales personnel salary/Sales commission
- Bad debt
- CPE/Distribution of CPE
- Product development/management
- Common costs.

It would be expected that the type and level of retail costs would vary according to the type of product and maturity of the market. Should there be any wholesale costs faced by OLOs but not by MT Retail, it is proposed that this should be taken into account, reflecting any extra incremental wholesale costs faced by a market entrant but not by MT Retail. It is proposed that any additional wholesale costs of this kind are considered over the customer's lifetime, and it is noted that the view of customer lifetime will vary across markets.

2.7 Cost base

It is proposed that a Discounted Cash Flow (DCF) approach may not be appropriate due to its dependence on the SMP operator's forecasts and assumptions, and also because a DCF approach allows the SMP operator to incur substantial initial losses which would be compensated in the future, and this would not likely be feasible for market entrants. However, a DCF approach is useful in assessing emerging fast-growing markets, and may be considered in those circumstances.

It is proposed that costs and profitability (see below) are calculated on a static basis.

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[5] Note that it is incremental costs which are considered. While avoidable costs are generally employed in ex post investigations, they may provide too low a threshold for retail prices.

It is proposed that a period-by-period approach is adopted. It is proposed that the period to be considered may vary with the maturity and/or volatility of the market in question.

BEREC guidance indicates that retail costs can be implemented as either a percentage mark-up on total network costs (regulated wholesale costs, non-regulated wholesale and own network costs) or as actual values that are added to total network costs.

Due to the lack of historic separated accounting information, the Commission will review retail cost elements for each market with MT, prior to the submission of compliance statements.

2.8 Measure of profitability

The ERT assumes that the market entrant should be able to make a reasonable profit on its retail service, and so a measure of profitability should be included in the calculation. It is noted that the wholesale input price includes MT's agreed WACC. The profitability to be considered in the ERT is therefore the profitability associated with the retail service only.

3. Implementation

3.1 Introduction

The direction not to cause a margin squeeze is an *ex ante* obligation, and as such applies to all existing and potential products and services in the defined markets. This means that MT is responsible for ensuring that products and services in the markets where it has been designated with SMP are not subject to margin squeeze, and this includes products and services which are currently in the market, and those which have yet to be launched.

It is proposed that MT is responsible for ensuring that it is compliant with its obligation not to cause a margin squeeze.

3.2 Process

MT has obligations regarding advance notification of price changes under its SMP obligations and under the terms of its licence. In the case of retail prices, customers must be informed of any modification to their contracts which is likely to be of material detriment to the consumer (which would include price changes) one month in advance (MT Licence Condition 8.3). In addition, in retail markets where it has been designated with SMP, MT is obliged to publish any proposed changes to price and non-price terms and conditions 30 days in advance of their coming into effect. In the case of wholesale prices in markets where MT has been designated with SMP, advance notification must give sufficient time for OLOs to respond.

Any launch of a new retail or wholesale product in a market where MT has been designated with SMP should therefore be accompanied by a statement of compliance with the ERT provided in writing to the Commission. It is proposed that any change to retail prices in markets where MT has been found with SMP and/or changes to wholesale pricing should be accompanied by a statement of compliance with the ERT provided in writing to the Commission. The Commission is currently reviewing the output from MT's BU cost model from which cost-oriented prices are being derived. The Commission expects that a change in wholesale pricing would be accompanied by a statement of compliance with the ERT in relation to MT's associated retail products.

The statement should include the following:

- Identification of relevant retail products
- Identification of wholesale input(s)
- Retail price
- Wholesale input price
- Retail costs

- Measure of profitability
- Margin

The Commission reserves the right to request supporting evidence and documentation.