The MCA's New Bottom-up Cost Model for Fixed Networks and Fixed Interconnection Prices

Response to Consultation and Decision

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Table of Contents

1 INTRODUCTION

On 9 October 2012, the Malta Communications Authority (hereafter 'the Authority' or 'MCA') published a Consultation and Proposed Decision entitled ‘*The MCA's New Bottom-Up Cost Model for Fixed Networks and Proposed Interconnection Prices*’ (hereafter 'the Proposed Decision'). The Proposed Decision summarised the model structure, the main network configuration assumptions and issues encountered in developing a bottom-up long-run incremental cost (BU-LRIC) model (hereafter 'BUCM2') for the purpose of costing fixed core and access services in Malta. The Proposed Decision also put forward the proposed fixed termination and origination rates emanating from BUCM2, as well as the proposals for the associated glide-paths.

The consultation period for the aforementioned Proposed Decision ended on 8 November 2012, with three operators, GO plc (hereafter ‘GO’), Melita plc (hereafter 'Melita') and Vodafone Malta Limited (hereafter ‘Vodafone’), submitting their formal feedback. The Authority would like to take the opportunity to thank the respondents for their contributions.

This Response to Consultation and Decision contains a summary of the feedback received from respondents, the Authority’s position in relation to these comments, and subsequently, the Authority’s corresponding final decisions. The report on consultation is organised in two major parts:

Sections 2 to 8 include an overview of various public consultation issues and the MCA’s position thereon, whereas Section 9 summarises the feedback received from the EU Commission;

Section 10 includes the prices for fixed wholesale termination and origination.

2 PRICE SETTING OF DATA SERVICES

2.1 Background

In Section 1.2 of its Proposed Decision, the MCA explained that the scope of the public consultation was to provide interested parties with a public description of the model in order to allow them to provide feedback on the modelling approach underpinning BUCM2.

The MCA further explained that the purpose of BUCM2 was to model the services of a hypothetical efficient operator with a view to set efficient regulated wholesale charges for fixed interconnection and leased lines including Ethernet connections[1]. In order to manage the price regulation of these services, the MCA proposed to split the price setting mechanism into two smaller blocks, namely a voice-related block and a data circuits counterpart. It further proposed to postpone the price-setting of the data-circuit block pending the conclusion of the market analysis for leased lines (market 6), which at the time was still under consultation.

2.2 Summary of Responses

Vodafone expressed its reservations on postponing the price-setting of the data-circuit services. Vodafone went on to state that although it appreciated that the MCA would want to wait for the market analysis for the provision of dedicated capacity over leased lines in Malta, it did not agree with separating this from the decision on voice termination and origination price setting mechanism. In view of the above, Vodafone was of the opinion that the MCA should not have proposed the fixed origination and termination rates without also taking into consideration the wholesale charges for leased lines.

Vodafone also stated that it did not exclude further submissions on the proposed model as impacting the leased circuits block when its respective consultation is issued.

[1] The MCA reserved the right to amend this list of regulated service in accordance with future exigencies and developments in the relevant markets.

2.3 MCA response and Decision

A number of clarifications are in order with regards to the above. First, the MCA would like to highlight the fact that, as clearly demonstrated in the Proposed Decision, BUCM2 does treat all the fixed-network services (including leased circuits and voice) holistically. However, one needs to distinguish the costing methodology used to cost regulated services from their price setting counterpart. Whilst the shared nature of fixed services requires them to be modelled together, their regulatory price setting regime is influenced by other criteria, such as the conclusions of the relevant market analysis and the relevant EC recommendations.

In this regard, given the EC Recommendation[2] on the regulation of termination rates, as well as the timing of the market analysis on leased lines, the MCA stands by its decision to keep the pricing regime of these two service blocks separate. Such a stance enables the Authority to take utmost account of the Recommendation whilst at the same time affords the required legal certainty by postponing the pricing of leased circuits till after the corresponding market analysis decision.

The MCA fails to understand the basis for the stance taken by Vodafone, when it stated that it does not exlude further submissions on the proposed model as impacting the leased circuits block when the respective consultation is issued. As clearly stated in the Proposed Decision, one of the aims, if not the central one, of this document was to consult on the modelling aspects of both the core and access modules of the BUCM2. These modules were covered in Sections 2 to 7 which focused on the network configuration, market module and common inputs of the model in their entirety. In fact in Section 1.2 of the Proposed Decision, the MCA asked specifically for this feedback from respondents.

The Proposed Decision was specifically designed in this manner so that at the end of the consultation period, the MCA would be in a position to have a stably rooted model upon which to base the price setting of the regulated fixed services. This is because, due to the shared nature of the modelled services, subsequent changes to the cost base would impact all the services modelled. For this reason, the MCA is not in a position to entertain any additional feedback on the modelling parameters beyond this consultation phase. The MCA feels the consultation document was comprehensive and clear enough on what was being requested from stakeholders.

[2] Commission of the European Communities, COMMISSION RECOMMENDATION of 7.5.2009 on the Regulatory Treatment of Fixed and Mobile Termination Rates in the EU, 7 May 2009.

3 WEIGHTED AVERAGE COST OF CAPITAL

3.1 Background

The Proposed Decision referred to the consultation document published in September by the Authority on the review of the weighted average cost of capital (WACC) (hereafter 'WACC Consultation'). The Proposed Decision specified that once the WACC decision is published, the model shall incorporate the revised WACC rate.

In view that the WACC Consultation was being carried out in parallel with this workstream, for the sake of clarity and without prejudice to the outcome of the WACC Consultation process, the MCA, where relevant, had disclosed the proposed fixed interconnection prices using both the WACC rate currently in force, as well as the proposed WACC rate.

3.2 Summary of Responses

GO stated that the publication of the fixed interconnection rates based on '*WACC levels still under consultation gives a perception signal to the market of a certain finality to the consultation process*'. GO then reiterated its comments raised in relation to the WACC consultation, in which it expressed reservations on the fact that insufficient allowance was made for Malta's market size and situation. GO also claimed that this same issue seemed to apply also to the BUCM model. GO further argued that reducing GO's WACC rate and the pressure to reduce its tariffs '*makes investment in GO less attractive due to perceived higher risk*'.

3.3 MCA response and Decision

In its Proposed Decision, the MCA published:

- the proposed rates based on the WACC rate currently in force (i.e. 12.56%); and
- the proposed rates based on the MCA's proposed WACC rate of 9.65%.

In so doing the MCA wanted to give the market a clear indication of the range within which the new interconnection prices would lie, other things being equal. As a matter of fact, the fixed termination rate using the above two WACC rates results in a range of between 0.046 EURcent/min and 0.0443 EURcent/min i.e. less than 5% difference. As for the fixed origination rate, the proposed rate varied between 0.2753 EURcent/min and 0.2643 EURcent/min with yet again a difference of less than 5%.

As to the comments raised by GO in relation to the WACC Consultation contending that not enough allowances were made for market size and situation, the MCA refers GO to the response to Consultation and Decision on WACC published by the Authority on 20 November 2012.

4 ASPECTS RELATED TO THE DEVELOPMENT OF THE BUCM2

4.1 Background

In its Proposed Decision, the MCA gave a comprehensive overview of the principles of long run incremental costing adopted in the model, the model structure, network configuration, market considerations and other common inputs, and details on service costing. The MCA also considered how services provided over the fixed network would be treated, and in relation to voice termination also referred to the 2009 EC Recommendation on fixed and mobile termination rates which prescribed that fixed termination rates should be:

- Calculated with a bottom-up LRIC model of an efficient modern network with a converged next-generation core network;
- Calculated with the pure LRIC increment.

Following the principles set forth in the above-mentioned Recommendation, the MCA proposed a wholesale fixed termination rate of EURcent/min 0.044[3].

4.2 Summary of Responses

Melita and Vodafone did not make any submissions specific to Section 2 to Section 6 of the public consultation. GO made reference to aspects which related to the private consultation, amongst which it emphasised that an operator the size of GO operates at below typical minimum efficient scale levels and consequently, given that GO's network is one of the smallest in the EU, the local FTR should stand well above the average of EU countries.

With respect to the proposed fixed termination rates included in the public consultation, GO argued that these were well below the average of the EU Member States prices as at 1 January 2012[4]. GO further argued that the fixed termination

[3] Only the prices based on a WACC rate of 9.65% have been reproduced in this document in view of publication of the WACC Decision in the interim.

[4] GO produced a table showing the applicable fixed termination rates within the EU as at 1st January 2012

rate as calculated by the MCA is almost half that of France (EURcent/min 0.08) and almost equal to the termination rate of Italy expected in 2015.

4.3 MCA response and Decision

The MCA fails to understand the logic of comparing the proposed Maltese fixed termination rates that will be in force in June 2013 with the rates of the other EU26 Member States as they stood in 1 January 2012, without even making the necessary qualification on which rates are based on pure LRIC as opposed to other methodologies.

GO's argument that the consideration of an operator the size of GO, which operates at below typical minimum efficient scale levels, should bring about a pure LRIC rate well above the average of EU countries, goes counter to the Pure LRIC methodology. The fact that an operator operates below typical minimum efficient scale only means that the cost of the absolute majority of the network elements that are traffic dependant does not vary with the removal of the wholesale voice termination increment. This was explained in detail in both the public consultation as well as during the technical consultations with GO.

The relationship between scale and 'pure' LRIC increments can be summarised as follows:

- economies of scale become less relevant, as the source for economies of scale is typically a sharing of common resources across a larger volume. These common resources are however no longer allocated to the FTR in a pure LRIC model
- an 'extensive' minimum configuration compared to the full network can, when a pure LRIC methodology is used, lead to the opposite impact compared to that expressed by GO. In the theoretical example where a network is operating at the minimum configuration scale when it provides all services, the impact on the total costs of removing the demand for one service (e.g. wholesale fixed termination) would in fact be zero. Thus, pure LRIC can be inversely related to scale, and this is indeed in line with international evidence.

In conclusion, the MCA is satisfied that BUCM2 is robust and dynamic enough to assist the Authority in setting efficient regulated charges for, but not limited to, fixed interconnection services.

5 TIME OF DAY GRADIENTS

5.1 Background

The wholesale termination prices in force to date differentiate between peak, off-peak and night calls through the application of a time-of-day gradient on the calculated output of the BUCM. This gradient was calculated by reference to the retail prices set by GO. Over the years, the retail pricing in the Maltese market has developed in a way that makes such time-of-day gradients less applicable. Therefore the MCA proposed to do away with these gradients and apply instead a uniform average charge. This affords operators more leeway to decide whether and how to differentiate their retail pricing.

5.2 Summary of Responses

No comments were received.

5.3 MCA response and Decision

In the absence of any adverse comments, the MCA reaffirms its position to remove the time–of-day gradients and to apply a uniform average charge.

6 GLIDEPATHS

6.1 Background

In its Proposed Decision, the MCA took cognisance that the proposed new interconnection rates:

- represented a significant drop vis-a-vis the current prices;
- brought about a change in the charging mechanism as time-of-day gradients are removed.

In view of the above, the MCA considered applying a glide path as shown in Tables 1 and 2 hereunder:

Table 1: Glidepath considered for fixed termination rates calculated using WACC rate of 9.65%[5]

	Step 1	Step 2
From	1 January2013	1 July 2013
To	30 June 2013	31 December 2013
Price (EURcent / min)	0.3803	0.0443

[5] Only the prices based on a WACC rate of 9.65% have been reproduced in this document in view of publication of the WACC Decision in the interim.

Table 2: Glidepath considered for call origination rates calculated using WACC rate of 9.65%[6]

	Step 1	Step 2
From	1 January 2013	1 July 2013
To	30 June 2013	31 December 2013
Price (EURcent / min)	0.4903	0.2643

6.2 Summary of Responses

Melita noted that through the glidepath the introduction of the call termination rates based on Pure LRIC principles will be delayed until the end of 2013.

Melita disagreed fundamentally with the glidepath proposal arguing that GO has for several years enjoyed the benefits of reaping monopoly rents from excessively high fixed termination charges. Melita further argued that operators purchasing call termination services and end-users who ultimately pay for retail calls on the basis of inflated call termination services should not be penalised any further by GO's monopoly pricing and so GO should not be given the benefit of any glidepath.

Melita argued further that the MCA's proposal for such a glidepath runs contrary to the Termination Rate Recommendation which specifies that pure LRIC-based rates should be put in place by end 2012 at the latest.

On the other hand, GO stated that in view that the reduction from the existing termination and origination rates is of almost 94% and 62% respectively, a glidepath of 6 months was too short to minimise the disruptions in the market. GO argued that this will create a substantial negative impact on GO's finances and will severely distort its financial budgeting plans at a crucial year where important NGA investment decisions will have to be taken.

GO further noted that other EU Member States that will be implementing a pure LRIC model are proposing longer glidepaths. It stated that AGCOM is proposing a glidepath up till 2015; this when the drop in FTR is lower than that of Malta. GO

[6] ibid

further notes that many EU Member States will still be implementing pure LRIC rates in 2013 and even beyond, thus giving their respective operators more time to prepare for and absorb reductions. Accordingly, GO argued that the MCA should seriously consider lengthening the timeframe of the proposed glidepath and lengthen the period of implementation of the pure LRIC rates.

GO's concluding remark was that any reductions, even where not as dramatic as the ones being proposed, should be implemented over a more reasonable period of time.

6.3 MCA response and Decision

At the outset, the MCA disagrees categorically with Melita's views that GO was enjoying monopoly rents from termination. The MCA would like to highlight the fact that as from 2006, fixed-termination rates have been set on the best practice methodology (prior to the EC Recommendation) of LRAIC+ based on a NGN core network environment in line with the industry dynamics at the time. For this reason the extent of change in the level of fixed termination rates observed in the consultation document is mainly attributable to a change in the costing methodology in line with the EC Recommendation, a change to an All-IP NGN Model and, albeit to a lesser extent, more sophisticated valuation methods, while the falling input prices in the core network featured in BUCM2 contributed as well.

In the MCA's view, the fact that the considerable resulting change in termination rates is mainly driven by a methodological change justifies a reasonable, glidepath. The European Commission has also been sensitive to the merits of minimising price shocks as much as possible as evidenced by the concessions given to various NRAs to reach their pure-LRIC mobile termination rates by end June 2013. This apart from the Commission's pronouncements made in the Recommendation on accounting separation and cost accounting systems under the regulatory framework for electronic communications (2005/698/EC) which states:

'*The implementation of a new or revised costing methodology may indicate that current levels of regulated charges and/or price mechanisms are inappropriate or misaligned in some way. If a national regulatory authority believed corrective action is required then due regard should be taken of the commercial and economic environment to minimise risk and uncertainty in the relevant markets. This action could include, for example, spreading any price adjustment over a reasonable period of time.*'

Therefore, the Authority considers that in the circumstances a glidepath adequately addresses the risks associated with introducing shocks in the market through abrupt price reductions.

However, the Authority has to balance out the needs of all operators in the termination market, which in itself exhibits a zero-sum outcome. For this reason it opted for a relatively short glidepath.

As for GO's reference to proposed glidepaths of other NRA's, the MCA notes that, to date, it does not know of any Article 7 notification that was cleared by the EC with a longer glidepath for FTRs. In any case, in view of the zero-sum characteristic of the termination market, the MCA stands by its initial position that the proposed glidepath is adequate for the local context.

In conclusion the MCA fails to understand, Melita's logic when it stated that the glidepath would result in the pure LRIC rates to be delayed until the end of 2013. Figures 8.2 and 8.3 of the Proposed Decision clearly show that the proposed glidepath sets the pure-LRIC termination rates applicable from 1st July 2013.

7 ASYMMETRY BETWEEN CALL ORIGINATION AND TERMINATION

7.1 Background

To date the fixed termination and origination charges were identical as a result of assuming the same increment for calculating the cost of two services that use the same network elements. The 2009 EC Recommendation does not provide direct guidance on the cost standard to be used for the setting of fixed origination rates. However, it explicitly states that the origination service should not be part of the same increment as the termination service. Accordingly, the MCA proposed to keep basing the cost of the wholesale origination service on a LRAIC+ increment.

7.2 Summary of Responses

Melita stated that whilst it understood the MCA's rationale for departing from symmetrical charges for fixed origination and termination rates, it questioned whether or not this reasoning should give rise to such a large disparity between the proposed rates. Melita also stated that the MCA did not elaborate on why it has chosen to use a LRAIC+ for origination rates and that it should have considered other options for setting these rates.

7.3 MCA response and Decision

The MCA was first and foremost guided by the EC Recommendation which infers a different treatment of origination and termination rates. This was explained in the Proposed Decision, which featured the following abstract from the said Recommendation.

"*From the traffic-related costs only those costs which would be avoided in the absence of a wholesale call termination service being provided should be allocated to the relevant termination increment. These avoidable costs may be calculated by allocating traffic-related costs first to services other than wholesale call termination (e.g. call origination, data services, IPTV, etc.) with only the residual traffic-related costs being allocated to the wholesale voice call termination service*."

As also stated in the Proposed Decision, other NRAs have also discussed the merits of a different treatment of these two rates. Once the legitimacy of using a different methodology was established, the rationale of which has been understood by the respondent, the MCA felt that LRAIC+ was the most appropriate costing methodology to apply. This is because it allows for the recovery of common and joint costs, and is as such the best practice approach for costing other regulated services throughout Europe. The argument is therefore the reverse - that termination is being treated differently - in line with the Recommendation's preference to pure-LRIC. In reaching its conclusion in favour of a 'pure' LRIC methodology for termination services the Commission highlighted a number of specificities of this market, including:

- that termination services can be considered to represent two-sided markets where both the calling and the called party benefit from the interconnection;
- that every operator holds SMP for termination on its own network and all networks offer this wholesale service to other operators in the market.

On the other hand, the costing methodology for origination services in BUCM2 continues to be set on LRAIC+, a methodology that (along with LRIC+) has been widely recognised as the most appropriate methodology for the calculation of cost-oriented wholesale charges for access to the incumbent's network.

8 Annual Revisions to the Fixed Interconnection Pricing

8.1 Background

In its Proposed Decision, the MCA put forward the proposed call termination and origination rates for 2013. The MCA stated that it would keep the proposed glidepaths under review and reserving the right to make the necessary amendments if any abonormal activity is detected during its course.

8.2 Summary of Responses

Melita noted that in the Proposed Decision no mention was made on how the fixed interconnection rates will be reviewed in the future and in particular noted that there is no commitment on the MCA's part to review and publish details of the fixed interconnection rates on an annual basis with no glide-paths.

Melita expressed the view that such a commitment is required to ensure that the fixed interconnection rates continue to be set on an efficient, forward-looking basis.

8.3 MCA response and Decision

The MCA would like to draw Melita's attention that the modified tilted annuity valuation methodology described in the Proposed Decision already features the forward-looking characteristics advocated by Melita. In this regard, as explained in the Proposed Decision, the Model takes into account the expected input prices, changes in demand as well as asset utilisation. For this reason, the MCA does not feel that there is the need for a strict annual revision, although the MCA will be keeping the model's parameters under review and reserves the right to update them as deemed necessary, in accordance with future market developments, and following an appropriate consultation period with stakeholders. Furthermore, in the interest of regulatory certainty, the MCA will be issuing an annual statement, notifying all stakeholders on whether it would be starting the review process of the model/rates in the subsequent year.

9 Response from the EU Commission

9.1 Summary of the Commission's Comments Letter

On 14 December 2012, the Commission sent its final comments pursuant to Article 7 (3) of Directive 2002/21/EC (hereafter 'Comments Letter') concerning the MCA's notification. In its comments letter, the Commission, whilst noting that the proposed measures were not fully in line with the Termination Rates Recommendation (according to which NRAs should ensure that symmetric termination rates were set at a cost-efficient (pure LRIC) level by 31 December 2012), recognised that:

- regulators need to strike a balance between protecting consumer welfare and avoiding a disproportionate negative impact on operators;
- NRAs thus have a certain margin of discretion, which could allow them to delay to a certain degree the introduction of fully cost-oriented rates.

Accordingly, the Commission commented that the proposed delay in the implementation of symmetric cost-oriented fixed termination rates, which in no circumstances should last beyond 1 July 2013, may exceptionally be acceptable in this case.

Nevertheless the Commission invited the MCA to take full account of the Termination Rates Recommendation and to consider setting cost-efficient fixed termination rates for all operators as of 1 January 2013 so that the full benefits of low fixed termination rates in Malta can more quickly be brought to Maltese and EU end-users.

9.2 MCA response and Decision

The MCA noted positively that the Commission has not made comments on the modelling and pricing approaches of BUCM2. The MCA also notes positively that the Commission recognised the need for NRAs to strike a balance between protecting consumer welfare and avoiding a disproportionate negative impact on certain operators. This consideration is even more relevant when one considers that the change in the fixed termination rates is mainly reflecting a methodological shift in the calculation of termination rates rather than a correction for excessive pricing.

In this regard, after taking into account the Commission's comments, the MCA concluded that it should proceed with the Decision shown in Section 10 below.

10 MCA'S DECISION ON FIXED-LINE WHOLESALE ORIGINATION AND TERMINATION RATES

MCA Decision:

After taking into account the feedback from respondents, the MCA is hereby mandating the glidepaths featured in Tables 3 and 4 below for fixed wholesale termination and origination services respectively which will be made applicable from 1 January 2013.

The charges shall be applicable to all those operators having an SMP in the wholesale fixed termination and/or origination markets. These charges shall remain applicable, as a minimum, until 31 December 2013.

Going forward, the MCA will be issuing an annual statement, notifying all stakeholders on whether it would be starting the review process of the model/rates in the subsequent year.

Table 3: Glidepath for Fixed Termination rates

	Step 1	Step 2
From	1 January2013	1 July 2013
To	30 June 2013	31 December 2013
Price (EURcent / min)	0.3803	0.0443

Table 4: Glidepath for Fixed Origination rates

	Step 1	Step 2
From	1 January 2013	1 July 2013
To	30 June 2013	31 December 2013
Price (EURcent / min)	0.4903	0.2643

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