



Contribution of Orange / France Telecom Group to the Consultation on the Draft Commission Recommendation on the Regulatory Treatment of Fixed and Mobile Termination Rates in the EU

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Orange / France Telecom Group (“OFTG”)

Orange is the key brand of France Telecom, one of the world's leading telecommunications operators.

France Telecom serves close to 174 million customers in five continents as of June 30, 2008, of which two thirds are Orange customers. The group had consolidated sales of 52.9 billion euros in 2007 (26.3 billion euros as of June 30, 2008). As of June 30, 2008 the group had 113.8 million mobile customers and more than 12 million broadband internet (ADSL) customers.

The group's innovation and strategy are characterised by the convergence of fixed, mobile and Internet services and the distribution of content across all platforms.

In 2006, Orange became the group's single brand for internet, television and mobile services in the majority of countries where the company operates, and Orange Business Services the name for services offered to businesses worldwide. France Telecom is the number three mobile operator and the number one provider of broadband internet services in Europe and one of the world leaders in providing telecommunication services to multinational companies.



Executive summary

OFTG has serious concerns about the draft Recommendation

Orange France Telecom Group welcomes the opportunity given by the Commission to express its views on the draft Commission Recommendation on the Regulatory Treatment of Fixed and Mobile Termination Rates in the EU (hereafter “the draft Recommendation”).

However, OFTG has strong concerns on the content of the document. The draft Recommendation proposes extreme measures with significant economic and legal implications and the Commission offers little justification for such a disruptive intervention in the European electronic communications sector. We are extremely concerned that the European Commission has prepared this draft Recommendation over what is essentially a politically predefined position; to eliminate mobile termination rates¹ across Europe, irrespective of how rational cost methodologies are applied to reach these rates. We believe that the methodology that the Commission propose to reach this goal is flawed and moreover that the main assumptions of the draft Recommendation (e.g. alleged cross-subsidies between fixed and mobile markets; alleged impact of termination rates on convergent offers) are inaccurate. OFTG therefore calls for an overhaul of the draft Recommendation, eliminating the particularly disruptive propositions on cost measurement and cost allocations.

On the grounds of economic rationale, **OFTG strongly supports the adoption of an economically sound and consistent Long Run Average Incremental Cost (LRAIC)-based accounting methodology for setting termination rates in the EU.** Provided LRAIC are calculated – as per current practices - via a bottom-up model reconciled with top-down cost and engineering parameters, OFTG also strongly supports LRAIC of an efficient operator defined on a per country basis. OFTG accepts the principle of symmetry; on one hand for symmetric fixed termination rates (FTRs) between fixed domestic operators and on the other hand, for symmetric mobile termination rates (MTRs) between domestic mobile operators.

However, **OFTG is strongly opposed to the draft Recommendation’s proposal to effectively set termination rates below cost as defined by the LRAIC standard.** The draft Recommendation amounts to setting termination rates below cost as fixed and mobile operators would not be entitled to recover a fair part of their joint and common costs from termination and in the case of mobile operators would not be able to include “coverage costs” and so-called “non-traffic-related costs” in their MTR. The draft Recommendation suggests that operators may recover these costs from other services but does not consider the impact of this cost recovery on consumers nor the economic irrationality of recovering these costs on services other than termination.

¹ For an explicit statement in this regard before the consultation on termination rates was even launched, see Viviane Reding, speeches of 8 May at EITO (p. 6-7) and of 11 February 2008 at the World Mobile Congress (p. 3).



OFTG is concerned by the social and economic consequences of implementing such a cost accounting methodology whose impact has not been assessed by the European Commission. We are concerned that the approach set out in the draft Recommendation would lead to an inefficient level of consumption, competition and investment stifling innovation and ultimately **damaging one of Europe's biggest success stories: mobile communications**. We therefore recommend the European Commission performs its own **impact assessment** before adopting a final Recommendation.

There will be an undisputed negative effect on Prepaid Customers

Setting termination rates below costs would not result into a general decrease of customer prices but to economic transfers between categories of customers as follows:

- Prepaid customers typically receive many more calls than they make and a high proportion of prepaid customers do not make any calls at all. These customers would not generate any revenue if it were not for the termination charge. Therefore reducing the termination charge below cost makes this group of customers loss making to serve and stimulates a change in pricing structure.
- A change in pricing structure means that prepaid customers will have to pay more to maintain their current level of service.
- The European mobile communications model has flourished through the development of the prepaid market. Prepaid customers - representing circa 60% of the overall European mobile customers base - are at risk of increased prices, lower usage and potential service disconnection. As it will no longer be economic to serve low usage customers, the draft Recommendation could result in a new “communications divide” in Europe.
- The draft Recommendation would result in a transfer from low usage customers (typically prepaid) to high usage customers (typically postpaid) as prepaid customers must pay to cover the cost of their incoming calls.

In this way the most price sensitive customers will be impacted negatively by the Recommendation. **A study by Frontier Economics² forecasts a 9% reduction in mobile penetration across Europe** as a result of recovering the lost termination revenue through increased subscription charges. The effect of lower participation by customers mainly receiving calls has also been shown theoretically as reported in the recent IDEI Survey on the Economics of Termination Charges³.

Innovation and quality of service will be negatively impacted

Other customer segments will not be spared the drawbacks of the Recommendation; notably through a reduction of operators' investment in quality of service, network coverage and innovation in mobile broadband, multimedia services and handset devices. For instance, as a large proportion of price plans gradually move to flat rate pricing as termination rates fall, operators will have less incentive to invest in innovative solutions that improve quality and usage but do not bring extra revenues.

² Frontier Economics, 12 September 2008, “Assessing the impact of lowering mobile termination rates”

³ Bruno Jullien, Patrick Rey IDEI Report # 6 “Notes on the Economics of Termination Charges” September 2008



An expected decrease of handset subsidies will also curb the penetration of high end handsets / smartphones and thus reduce incentives for service innovation. Handset subsidies are used to encourage customers to take up new services as customers typically do not fully realise the benefits of a mobile device when they buy a new phone until they have become used to the new applications. Finally, the size of the European territories which offer sufficient returns for mobile operators to “naturally” invest in will reduce (as the population is geographically more concentrated than the mobile traffic). As in the case in the US market, **Member States will probably have to compensate through universal service funds and devise cumbersome regulation in order to maintain and increase the geographic penetration of mobile services in the EU.**

Fixed customers will also suffer

From the fixed termination side, the draft Recommendation is likely to result in an increase of fixed subscription fees⁴ (as joint and common costs will be reallocated from traffic to access services). The draft Recommendation fails to analyze this effect which **could result in an increase of line rental and/or LLU of more than 15%**. Moreover, in view of the wide range of services potentially able to bear the reallocated costs, one is likely to experience a development of inconsistent policies throughout the EU.

The draft Recommendation proposes a technically unsound cost methodology

Furthermore, from a more technical point of view, the draft Recommendation creates incorrect expectations. Accurately using bottom-up and current cost methodologies would indeed not lead per se to lower values for the termination rate. Expectations of considerably lower termination rates could only result from a technical misconception of how cost accounting methodologies should be applied. We are concerned that by imposing incorrect economic calculations as a regulatory standard, the draft Recommendation could erode the credibility of the European regulatory environment.

The draft Recommendation is legally unsound

The draft Recommendation seeks to regulate termination rates in a binding manner throughout the EU. It imposes - rather than recommends - on National Regulatory Authorities (NRAs) both a specific cost model and a fixed timetable to implement it. **From a legal standpoint, the draft Recommendation therefore amounts to a binding measure which falls outside the competence of the Commission as organized in the EU Regulatory Framework and in Article 19(1) of the Framework Directive.** Further, by seeking to regulate an area that, in the general scheme of the EU Regulatory Framework, has been reserved to the Member States (in particular to NRAs), the draft Recommendation violates the principle of allocation of competences and subsidiarity enshrined in Article 5 EC Treaty. Finally, by deliberately excluding a whole range of relevant costs from termination, the draft Recommendation goes beyond the principle of cost orientation enshrined in Article 13 of the Access Directive.

OFTG's proposed amendments

OFTG strongly supports the adoption of a consistent, socially desirable, legally and economically sound cost accounting methodology in the EU. With this goal in mind, rather than proposing a

⁴ Depending on the local retail regulatory situation



radical overhaul of proven principles, OFTG suggests to build from the principles set out in the Commission Recommendation of 8 April 1998 on interconnection in a liberalized telecommunications market.

In the draft Recommendation, OFTG proposes to retain the following principles already set out in the Commission Recommendation on interconnection in a liberalized telecommunications market:

1. Inclusion of joint and common costs in the termination rate calculation.
2. Inclusion of both relevant coverage related and capacity related costs of termination.
3. Inclusion of all radio access costs and spectrum costs (both traffic related costs) for mobile
4. Allowance of full costs of termination to be recovered from the termination service.
5. Encouragement of NRAs to take into account of the short and long term effect on investment in their termination rate determination.

OFTG further suggests the following amendments to the draft Recommendation:

6. To encourage NRAs to use and calibrate both bottom up and top down models to reach an efficient cost of termination as a reference for per country symmetric termination rates.
7. To retain the principle of technology neutrality. NRAs should be allowed to consider using NGN core network costs and 2G/3G access network costs only as far as they are appropriate, industrially mature, replacement technologies to serve actual retail and wholesale services.

European NRAs have translated the evolution of cost in the mobile industry into a 40% decrease⁵ in MTRs over the past four years. The European Regulators Group (ERG) members have made a commitment to further reduce mobile termination rates and expect a reduction of about 40% in the coming three years. Gradual reductions in cost which reflect the progress of the industry towards greater efficiency are good for consumers as mobile operators are able to pass these price reductions on through naturally evolving business models. Sudden drops in MTRs which do not reflect the real cost environment will have a distortionary impact. By issuing a Recommendation incorporating the changes recommended above, the European Commission will provide European NRAs with the appropriate tool to set termination charges consistent with their objective to achieve further reductions.

⁵ ERG Press Release 3 June 2008

http://www.erg.eu.int/doc/whatsnew/erg_08_32_25th_plen_vilnius_%20press_080603.pdf



Table of Contents

1. INTRODUCTION	8
2. ASSESSMENT OF THE DRAFT RECOMMENDATION	9
2.1. IMPACT ON MOBILE CONSUMERS	9
2.1.1. <i>Effect on price structures: The draft Recommendation would drive prices up for all prepaid customers</i>	9
2.1.2. <i>Impact on service penetration: millions of EU citizens will not be able to keep their mobile phones</i>	11
2.1.3. <i>Effect on quality of service</i>	13
2.1.4. <i>Effect on smaller players: customers affected by disruptions in a competitive environment</i>	14
2.2. IMPACT ON FIXED CONSUMERS	15
2.3. LEGAL ASSESSMENT (SUMMARY)	15
2.3.1. <i>The draft Recommendation is a binding regulation in disguise</i>	15
2.3.2. <i>The draft Recommendation would result in below cost orientation instead of cost orientation</i>	16
3. SUGGESTED CHANGES TO THE METHODOLOGY	17
3.1. REMOVE INCORRECT REFERENCES TO MARGINAL COST PRICING	17
3.2. DEFINITION OF INCREMENTAL COST	18
3.3. ACCESS NETWORK COSTS - THE DIFFERENCE BETWEEN FIXED AND MOBILE NETWORK COSTS	19
3.4. COST RECOVERY FROM OTHER NON-REGULATED SERVICES	20
3.5. EFFECT ON INVESTMENT	21
3.6. THE CORRECT APPROACH TO CALIBRATING LRIC MODELS	21
3.7. TECHNOLOGY NEUTRALITY	22
4. CONCLUSION	23
ANNEX 1 LEGAL ASSESSMENT	24
1. <i>The draft Recommendation amounts to a regulation in disguise</i>	24
2. <i>The draft Recommendation exceeds the boundaries of the Commission's powers under Article 19 of the Framework Directive</i>	25
3. <i>The draft Recommendation is incompatible with Article 13 of the Access Directive as it misapplies the concepts of excessive pricing and cost orientation</i>	27



1. Introduction

The European Commission submitted a draft Recommendation for consultation which, if adopted, requires NRAs to set fixed and mobile termination rates for operators with significant market power in the wholesale markets for termination according to a newly recommended cost model. In a nutshell, the model proposed by the draft Recommendation should comply with the following characteristics:

- Based on current cost and based on a bottom-up approach using long-run incremental costs (LRIC);
- Based on efficient technologies available with core parts being based on Next-Generation-Networks and mobile networks on a combination of 2G and 3G networks;
- Based on an appropriate efficient scale for an operator (fixed or mobile);
- Result in symmetrical termination rates;
- Use economic depreciation of assets;
- Exclude so-called “non-traffic related costs” (these costs need to be attributed to services other than wholesale termination services);
- Exclude common costs, joint costs, spectrum costs (except to the extent additional spectrum is acquired to provide wholesale termination services), coverage costs.

OFTG has serious concerns with the proposals made under the draft Recommendation. The draft Recommendation proposes extreme measures with significant economic and legal implications with little justification for such a disruptive intervention in the European electronic communications sector. OFTG wishes to take this opportunity to respond to the European Commission’s draft Recommendation by setting out firstly our assessment of the draft Recommendation (section 2) and suggesting some changes to the methodology proposed by the Commission (section 3). In conclusion (section 4), we emphasise that a better social and economic outcome would be achieved if the future Recommendation naturally builds from the steady application of existing principles and practices.



2. Assessment of the draft Recommendation

As stated earlier, OFTG is of the view that the Commission is proposing extreme measures with significant economic and legal implications without putting forward any robust justification.

The Explanatory Note provides (p.6): “[...] with the evolution of fixed-mobile hybrid services and a move towards convergence, a different regulatory treatment of fixed and mobile termination rates raises a possible inconsistency issue”.

To our mind, there is little justification for linking the development of convergent offers and the requirement for greater consistency in the regulatory treatment of fixed and mobile termination rates. We are of the view that there has not been sufficient proof of distortion of competition between fixed/broadband and mobile retail markets to justify a far reaching regulatory intervention.

Likewise, the Explanatory note states (p.14): “currently, there are net transfers of wholesale termination revenues from fixed network operators from mobile network operators, creating an effective cross-subsidy between fixed and mobile markets and consumers [...]”.

OFTG is surprised by such a statement. The existence of a cross-subsidy between fixed and mobile markets and consumers is indeed not documented. Today, it is not a general truth that average price per minute paid for a fixed to mobile call and for a mobile to fixed differs widely one from the other. It is therefore difficult to make a generalisation that a cross-subsidy exists between fixed and mobile subscribers.

On the basis of these questionable assertions, the draft Recommendation proposes extreme measures with significant consequences on mobile and fixed consumers as well as important legal implications. We will analyse these points in turn.

2.1. Impact on mobile consumers

2.1.1. Effect on price structures: The draft Recommendation would drive prices up for all prepaid customers

OFTG is greatly concerned by the unexpected social and economic consequences of implementing the cost accounting methodology outlined in the draft Recommendation. By excluding a whole range of costs currently included in the mobile termination rates, it will force operators to set termination rates below cost and, in turn, will severely restrict consumer choice notably by reducing options for prepaid subscribers. This could happen in a number of ways:

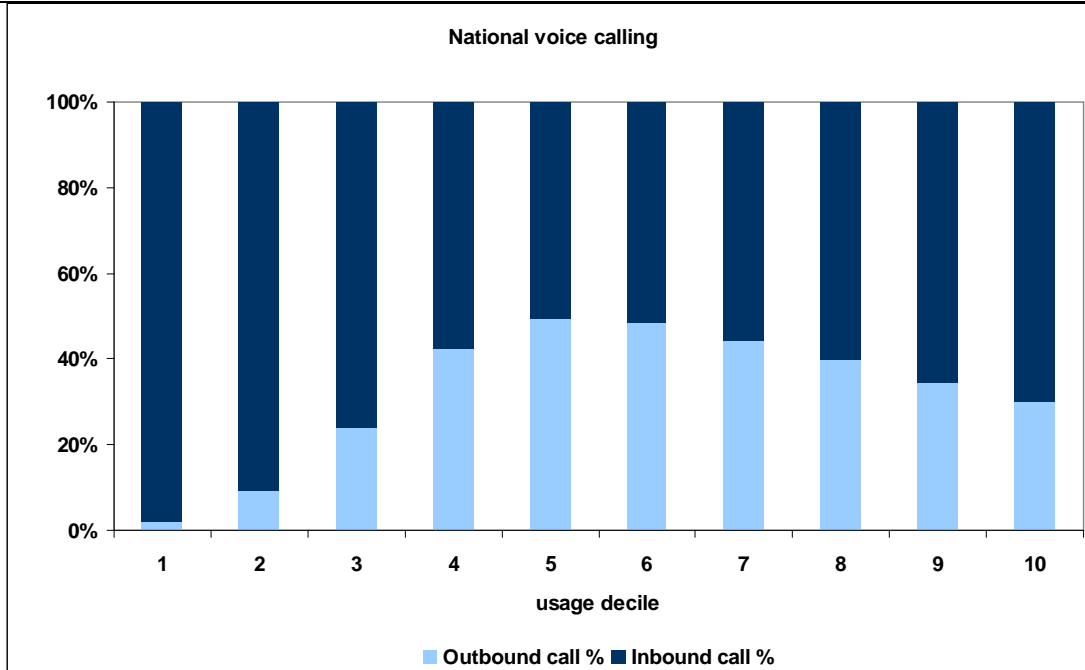
- Generalisation of flat rate propositions at a relatively expensive monthly price which will favour very high usage consumers.
- Degradation of propositions and reduction of options for low usage prepaid customers. Box 1 below shows that prepaid customers receive more calls than they make. Therefore without a termination rate that covers costs, low usage prepaid options whereby



customers mainly receive calls and make very few outgoing calls will convey an overall loss to the mobile operator.

Box 1: Prepaid customers and incoming calls in a European Orange operation

Prepaid customers receive more calls than they make as shown in the graph below which shows the percentage of calls which are inbound and outbound for each prepaid customer decile. Our internal analysis shows that this trend is the most extreme for the lowest usage customers who make very few outgoing calls.



- The options to recoup this loss of revenue could for instance be:
 - **To increase outgoing call prices.** The outgoing call price would need to cover both the cost of outgoing calls and the cost of incoming calls. Given that prepaid users predominantly receive calls the outgoing call price would need to increase more than for postpaid users, who typically make more calls than they receive.
 - **To introduce a charge for incoming calls.** With termination rates below costs and smart devices which can easily download programs to automatise these tasks⁶, we can expect a rapid development of call back services⁷. Operators still willing to address low usage customers with fair propositions may therefore have no other solution than charging for incoming calls as well as outgoing calls. However,

⁶ More than 60% of handset sold in 2008 incorporate an open operating system enabling customers to download software just like on PCs. These software can easily use the set up call or send SMS APIs.

⁷ For French phone booth, the cost difference between incoming and outgoing calls was about 3.5 cent€/min. Call back reached almost 50% of the traffic in 3 years. And yet, in that case, call back could not be easily automatized as it can and will be on mobile devices.



European consumers are likely to be hostile to the idea of paying for something which used to be free of charge in Europe.

- **To migrate the customer to a plan that will secure a minimum revenue to the operator.** This could either involve a migration from prepaid to a postpaid plan, setting up a minimum monthly fee payable to allow the prepaid customer to stay active on the network and receive calls and/or a gradual reduction of the duration of validity of the fee. Hence, where top up charges for prepaid are only valid for a limited period of time, operators are likely to greatly reduce the time period of validity in order to encourage customers to top up prepaid credit more frequently and to make up for lost termination revenue.
- **To change the current rules for disconnection for customers who do not make a sufficient number of calls.** There are currently rules for prepaid customers to make or receive a minimum number of calls over a defined time period to ensure that they stay active on the network. This time period could be shortened and customers will have to pay more to remain connected.
- **To increase mobile handset prices for prepaid customers by reducing subsidies.** This will present a problem for customers migrating from 2G to 3G services. As MNOs eventually turn off 2G networks, all customers will need to acquire 3G handsets to be able to use voice and data services. A reduction of handset subsidies will therefore be more expensive for low users to retain the benefit of mobile services.

Our internal analysis⁸ shows that across all European markets prepaid customers will end up paying more for an equivalent or reduced service, due to the lost termination revenue on these customers. This reduction will take form of different pricing structures as explained above and Independent economic research by Frontier Economics and IDEI confirms the outcome of our internal analysis.

2.1.2. Impact on service penetration: millions of EU citizens will not be able to keep their mobile phones

- The European model is founded on the calling party pays (CPP) system and as such has led to the prevalence of prepaid offers which enable European citizens to have mobile services at very low personal cost. In essence, postpaid customers do “subsidise” prepaid customers by choosing to make the call and by paying for the call. If this “subsidy” disappears, as explained above, one of the options available for operators to recoup their loss will be to charge for incoming calls (in essence shifting to a receiving party pays system). OFTG provides that such a shift would have a significant impact on penetration.

⁸ We have carried out an assessment of the effect of moving to very low MTRs across our European footprint. This has involved looking at different customer profiles and the relative mix of inbound and outbound traffic for both prepaid and postpaid subscribers and forecasting what the likely market pricing outcomes will be under different termination rate scenarios.



Indeed, as the examples outlined in the table below show, in a receiving party pays environment, penetration does not take off or else remains relatively lower than in a CPP environment.

Box 2: Receiving Party Pays vs. Calling Party Pays:

- In Slovakia, receiving party pays (RPP) was in place from 1991-1997, prior to the launch of Orange Slovenko, and attracted much consumer criticism. The switch to calling party pays in 1997 with the launch of prepaid and subsidised handsets has seen the take-off in mobile communications in Slovakia with penetration rising from 4% of the population in 1997 to 98% in 2008.
- The US model incorporates receiving party pays and correspondingly has a lower level of penetration overall at 85% compared to near full penetration in Europe (source: Frontier Economics). Moreover, the percentage of prepaid customers in the US is 15% (source: FCC) compared to 61% in Europe (source: EC's 13th Implementation Report). Hence, given the high proportion of mobile subscribers in Europe who are prepaid and only receive calls, it is fair to predict that charging these prepaid customers to receive their calls would not be welcomed by existing European prepaid customers.

- A change in pricing models will lead to a fall in prepaid penetration and a fall in usage for the lower end of the market as these consumers either will not be able to afford the same level of mobile service or will move to a postpaid subscription. As a result many prepaid consumers on low incomes will lose the benefits and flexibility that they currently enjoy with a prepaid phone. In this way, the methodology proposed under the draft Recommendation leads to a restriction of consumer choice.
- Switching to a fixed line will not be an option for a number of prepaid mobile customers left without communication device. Indeed, the fixed line subscription fee is likely to be above what a number of pre-pay mobile users can afford (especially if subscription fees increase as a result of the implementation of the draft Recommendation) while not offering the price control element that pre-pay mobile telephony can provide. Such customers would also lose the value of increased contactability that mobile communications offers.
- **We forecast that all prepaid customers (i.e. circa 60% of the overall European mobile customers base or 240 million customers) will see the total cost of owning a mobile phone increase to maintain the same level of service which they currently enjoy and are therefore at risk of a reduced level of service.**
- **The results of a study by Frontier Economics forecasts a 9% reduction in the total number of mobile subscribers (400 million) across Europe.** Frontier Economics have built a model based on the existing academic literature which sets out how competitive mobile operators



will price to recoup the loss of termination revenue. Without moving to receiving party pays (RPP), monthly subscription charges are raised to recover the loss of termination revenue. This increase triggers the fall in penetration. If operators were to introduce charges to receive calls the resulting impact on penetration would be felt even more strongly.

- The Frontier Economics study explains that a fall in MTRs will lead to an increase in minutes of use (facilitated by flat rate pricing) and for competing networks to increase monthly subscription charges to their subscribers to recover the losses made on calls but that the combined impact of these two factors is negative “reducing the benefit that consumers get from mobile services.”⁹
- Frontier Economics show that reducing termination rates to the level proposed by the European Commission would move Europe closer to a US type model where fewer customers consume more minutes but where the overall penetration is lower. This report confirms that US type bucket plans with very high call volumes simply will not suit low income, low usage European customers. The Frontier Economics study states “ US penetration levels applied to Europe would imply 154 million less mobile phones, which would significantly reduce European consumers’ welfare.”

2.1.3. Effect on quality of service

Lower termination revenues also means lower investment on quality of service, innovation and coverage.

As a large proportion of price plans will gradually move to flat rate pricing, operators will have less incentive to invest in innovative solutions that improve quality and usage but do not bring extra revenues.

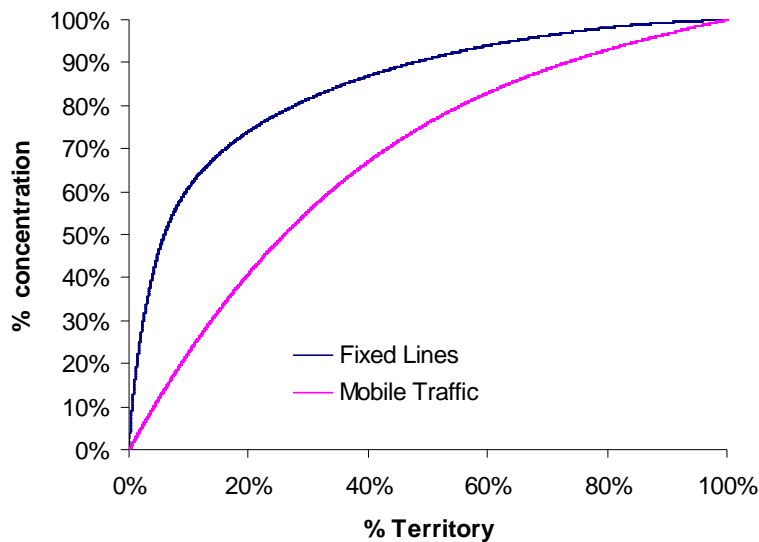
An expected decrease of handset subsidies will also curb the penetration of high end 3G handsets / smartphones and thus reduce incentives for service innovation. Along with a welfare loss for consumer, the resulting reduced penetration of expensive high end handsets (such as smartphones) could slow down the penetration of innovative mobile services (e.g. web browsing, IM, location based services, mobile payment, etc.) which are dependent on the take-up of 3G handsets. In the mobile ecosystem, the launch of an innovative service requires a combination of core network upgrades with an available stock of handsets that support the service. When the take-up of adapted handsets is insufficient to make the service profitable, investments in the core network and service innovation do not take place. In this way, an increase in handset prices will reduce incentives for service innovation.

The size of the European territories which offer sufficient returns for mobile operators to “naturally” invest in will reduce. The reason for this is that the population is geographically more concentrated than the mobile traffic as illustrated by the graph below:

⁹ Section 3.2.1 Frontier Economics, 12 September 2008, Assessing the impact of lowering Mobile Termination Rates



Geographical concentration compared Fixed Lines - Mobile Traffic



This graph shows that when mobile revenues stop being related to traffic and are instead related to subscribers, then the size of the geographical area where network roll-out is profitable becomes smaller. The long run sustainability of mobile service coverage in a large part of the territory will therefore be at risk.

Member States will probably have to compensate and devise cumbersome regulation in order to maintain and increase the geographic penetration of mobile services in the EU. Indeed, ETNO have recently released data which show that investment in the mobile sector has dropped by up to 9% in the five core EU markets in 2007.

Ultimately lower investment means poorer quality of service and a slower rate of development of new products and services. All customers suffer as a result.

Termination rates below cost can also lead to the prevalence of spam which requires legal measures and additional software to manage the issue to control for the problem, adding to the cost of service and ultimately reducing the quality of the customer experience. With low fixed termination rates, such spamming issues already exist. In several countries, fixed operators have developed solutions to filter incoming calls which do not present a caller ID. Such solutions are not free and can result in a 5 to 10% increase of line rental or broadband subscriptions.

2.1.4. Effect on smaller players: customers affected by disruptions in a competitive environment

In many countries, MVNOs firstly target low income or low usage consumers. Currently, MVNOs benefit from favourable economic conditions for targeting such consumers. However, reducing termination rates below cost will certainly force MVNOs to launch receiving party pays offers (as France Telecom Group – Response to the EC Consultation *Recommendation on TRs* - 10th September 2008



mobile network operators will have to protect themselves against MVNOs implementing call back systems) that will undoubtedly significantly disrupt MVNO activities. Low income and low usage customers will be the ones primarily affected by these disruptions.

Beyond MVNOs, below cost termination rates put small operators' business models at risk. As a large part of their traffic costs will not be covered anymore, small players will have to pass on these costs to their customer base (in one of the ways described above). Given that their customer base smaller, the disruptive impact of the cost reallocation should be more significant for these smaller operators.

2.2. Impact on fixed consumers

Following a similar logic, as the draft Recommendation proposes to set fixed termination rates (FTR) at an incremental level, the costs which will not be recovered in the FTR anymore will have to be reallocated to other services.

OFTG believes that the draft Recommendation is likely to result in an increase in fixed subscription fees. The draft Recommendation fails to analyze this effect which **could result in an increase of line rental and/or LLU of more than 15%**¹⁰. Therefore, low usage customers would also lose out in the fixed market. In some markets however, retail regulation may restrict the ability of fixed operators to adapt this pricing structure and alternatively these operators would be forced to recover costs from unregulated services which are typically nascent services such as broadband and multimedia services restricting the growth and take-up of these services.

Moreover, in view of the wide range of services potentially able to bear the reallocated costs, one is likely to experience a development of inconsistent policies throughout the EU.

2.3. Legal assessment (summary)

The draft Recommendation proposed by the Commission raises a number of legal concerns. These concerns are set out in detail in Annex 1 of this Response. We hereby only provide a summary of the key legal concerns raised by the OFTG as regards the draft Recommendation.

2.3.1. The draft Recommendation is a binding regulation in disguise

To begin with, the current language of the draft Recommendation, if adopted, would result in a Recommendation that is in fact a "regulation in disguise". The approach proposed by the draft Recommendation is mandated upon the NRAs instead of recommended. In effect, as from 31 December 2011, NRAs must have either implemented cost orientation remedies on termination rates on the basis of the proposed cost methodology or else impose termination rates that are not

¹⁰ E.g. in France, Wholesale line rental (WLR) is below €12/month, FTR are close to €0,5ct/min and consumer usage about 600min. (incoming + outgoing calls) per month. Setting FTRs near to zero would therefore increase WLR by €3/month.



higher than the average termination rates imposed by NRAs that have applied the said cost methodology (recommendations 10 & 11).

In OFTG's view, this runs contrary to Article 19(1) of the Framework Directive – upon which this draft Recommendation is based – and it fails to respect the balance of competences between Commission and NRAs as regards remedies imposed on termination markets.

2.3.2. The draft Recommendation would result in below cost orientation instead of cost orientation

The draft Recommendation proposes a cost methodology which goes beyond the cost orientation remedy of Article 13 of the Access Directive. The draft Recommendation excludes an important number of cost elements in its proposed model. The draft Recommendation is therefore contrary to the cost orientation remedy as provided for in the current Regulatory Framework.



3. Suggested changes to the Methodology

In this section we set out our suggested changes to the proposed methodology in order to avoid setting termination rates below cost and thus avoid the negative consequences explained in section 1. Rather than proposing a radical overhaul of proven principles, OFTG suggests to build from the principles set out in the Commission Recommendation of 8 April 1998 on interconnection in a liberalized telecommunications market.

3.1. Remove incorrect references to marginal cost pricing

The draft Recommendation proposes to set termination rates “as close to marginal cost as possible” (Explanatory Note, p.16) and proposes that joint and common costs should not be recovered from termination. Marginal cost pricing can be both allocatively and productively efficient but in the presence of fixed, joint and common costs as in the mobile network operator industry, marginal cost pricing cannot be sustained; operators can break even only by setting prices that are higher than marginal costs. This means that some of the products and services offered by a firm with fixed and common costs have to be priced above marginal cost. The only relevant question is to decide which services should be priced above marginal costs in order to cover fixed and common costs. In the absence of information concerning demand characteristics, the most sensible choice is to share evenly fixed and common costs between products and services, proportionally to the incremental costs; as per the EPMU¹¹ rule. If demand characteristics are known, fixed costs should be allocated to the least price sensitive products; as per the Ramsey-Boiteux pricing rule. However, the draft Recommendation proposes to depart from the EPMU rule without any reference to demand characteristics and therefore without sound economic justification.

This proposal draws no logical link from marginal cost pricing to the exclusion of joint and common costs and offers no explanation for why joint and common costs should not be recovered from termination. The suggestion is therefore implicit in the draft Recommendation that these costs should be recovered from unregulated services. However the draft Recommendation provides no basis for the Commission’s proposal that common and joint costs should be recovered elsewhere. This raises severe efficiency concerns, as when costs are recovered from the more elastic services there will be an impact upon customer’s consumption decisions to purchase other services.

The available evidence suggests that subscribers are relatively insensitive to the price of call termination. According to Ramsey pricing principles¹², this means that termination should bear relatively a large share of joint and common costs. Regulators have been reluctant, however, to apply Ramsey principles, in part because of their large informational requirements. Nevertheless, this evidence indicates that the presumption should be that at least some joint and common costs

¹¹ Equi-proportional Markup (EPMU)

¹² Prices should be set above cost for goods which have a fairly price insensitive demand according to the inverse elasticity rule.



are recovered from termination and any argument to the contrary has to provide logical and empirical evidence to support its case. The methodology proposed in the draft Recommendation provides no logical argument for the exclusion of joint and common costs. Therefore we propose that the methodology should be amended to keep joint and common costs to the LRAIC calculation.

Proposed change 1: Keep joint and common costs in the termination rate calculation

3.2. Definition of incremental cost

The draft Recommendation's definition of the incremental cost is confusing. On the one hand the draft Recommendation states in paragraph 13, that:

“Avoidable costs are the difference between the identified total long-run costs of an operator providing its full range of services and the identified total long-run costs of that operator providing its full range of services except for the wholesale call termination service supplied to third parties (i.e. stand-alone cost of an operator not offering termination to third parties).”

But on the other hand the draft Recommendation goes onto distinguish between traffic-related versus non-traffic-related costs; and attributing costs first to other services, and last to wholesale voice call termination. This second definition of incremental cost is very unclear.

The draft Recommendation then states that “coverage costs” should be excluded from the LRIC of the wholesale voice call termination increment. For example, on p. 10 of the draft Recommendation:

“The incremental cost of wholesale voice call termination services should therefore exclude coverage costs but should include additional capacity costs to the extent that they are caused by the provision of wholesale voice call termination services.”

Again, the draft Recommendation offers no explanation for why coverage costs should be deemed “non-traffic related” and excluded from the incremental cost of termination. In fact coverage does indeed provide traffic-handling capacity and an improvement of mobile coverage would result in increased mobile traffic (of existing subscribers) rather than increased subscriptions.

We firmly maintain that it is appropriate to include both coverage and capacity related costs in the calculation of the LRIC charge. This is because both coverage and capacity costs are traffic related costs. As the draft Recommendation acknowledges, capacity related costs are clearly traffic related and it is appropriate to include them in the LRIC calculation. Coverage related costs, however, are also traffic related (as extra coverage means extra traffic). They are not subscriber related as the draft Recommendation suggests. Allocating coverage costs to subscription would imply artificially pricing mobile subscriptions above marginal cost.



The draft Recommendation should keep the existing definitions of relevant costs for FTR and MTR and in particular - for mobile termination - including all relevant costs (not just capacity costs).

Any exclusion of coverage costs from the MTR calculation represents a major shift in accepted LRIC methodology. In Ofcom's cost modelling, for example, the great majority (over 80%) of coverage costs, in fact, provide traffic-handling capacity. It is unclear why such costs should be deemed to be "non-traffic-related", and hence excluded from the incremental cost of termination.

Proposed change 2: Keep both coverage related and capacity related costs in relevant mobile termination costs.

3.3. Access network costs - The difference between fixed and mobile network costs

Differences in fixed and mobile termination rates reflect objective differences in cost structures between fixed and mobile markets which are also recognized by the Explanatory Note (p. 6). The access network in fixed networks is copper wire plus the subscriber card for each individual subscriber and so the access network is entirely driven by subscribers. The costs of such access in fixed networks are recovered via the retail subscription charge. This is not the case for mobile networks where the "access" network is the radio access network – both spectrum and equipment (base stations and associated equipment) are shared between subscribers and not allocated to a single subscriber. With mobile networks, it is the coverage and the level of traffic, not the subscribers, which drives this cost of the access network. In other words, the radio access network is built and maintained for both coverage and capacity purposes; it is also built and maintained to make and receive calls. It does not include any subscriber dedicated resource and according to the Commission's definition of traffic and non-traffic related costs, the radio access network constitutes a wholly traffic related cost.

The suggestion in the methodology proposed by the draft Recommendation is that most of the cost of the access network should not be carried by the termination rates but (by implication) by non-regulated services. As explained in section on marginal cost pricing above, however, this runs contrary to economic rationale which states that it is most efficient to recover costs from the least elastic service. In a two-sided market, this means that costs should actually be recovered from the termination side.

Proposed change 3: Keep all radio access costs and spectrum costs (both traffic related costs) for mobile



3.4. Cost recovery from other non-regulated services

If the proposed methodology of the draft Recommendation were implemented and it is not possible to recover network costs from the termination side, then mobile operators would need to look at recovering these costs from other services such as access, outgoing calls or non-voice services such as mobile data. The Explanatory Note to the draft Recommendation explicitly envisages such alternative cost recovery through non-regulated services (see p. 15). However, the end result is likely to be simply that mobile operators cannot recover these costs:

- As regards cost recovery on outgoing calls, this would upset the equilibrium between terminated calls and outgoing calls. As they are substitutes to a degree, arbitrage would occur between the lower-priced call termination tariffs and higher-priced call origination tariffs. For instance, we can expect a rapid development of call back services. An uneven cost allocation between terminated calls and outgoing calls is therefore not sustainable. Non-recovered costs from termination cannot therefore be allocated to outgoing calls.
- Cost recovery from mobile data services is also not feasible in view of the emerging nature of this market. Shifting non-recovered costs to mobile data services would put a break on the development of this nascent market at the expense of both industry and consumers.
- Cost recovery from access (in the form of a subscription charge) or from call receipt charges (RPP) are clearly not envisaged in the draft Recommendation's logic, given that the suggested approach is seeking lower retail prices (see draft Recommendation, recital 7, last sentence and Explanatory Note, p. 15). In any event, even if operators were to recover costs from access or from the introduction of RPP, this would lead to an economic transfer from low usage customers (who receive more calls than they make calls) in favour of high usage customers (who do the contrary). Under these circumstances (i.e. if a subscription charge is raised and/or RPP is introduced), then prepaid **customers will suffer relatively higher prices due to the introduction of the Recommendation.**

More generally, the Explanatory Note states that the draft Recommendation facilitates efficient cost recovery (see p. 15). However, this is contradictory with the content of the text itself which explains that excluding costs from termination will reduce retail prices. Any trade-off between a hypothetical retail price decrease and possible increase of other retail prices is not envisaged. The draft Recommendation therefore refuses to consider that excluded costs must be re-allocated elsewhere. In doing so, the draft Recommendation imposes "below cost orientation" instead of cost orientation as described by Article 13 of the Access Directive. The draft Recommendation is therefore outside the scope of the current framework.

Proposed change 4: Continue to allow full costs of termination to be recovered from the termination service in accordance with Article 13 of the Access Directive



3.5. Effect on investment

If the proposed methodology of the draft Recommendation were implemented and it is not possible to recover network costs from the termination side, then over time investment will be negatively impacted. Operators would be forced to degrade the quality of service that they can offer customers, revisit the roll-out of 3G networks and will have reduced incentives for service innovation due to a lower penetration of adapted handsets. These fundamental short and long term links between termination rates and investment are completely disregarded by the methodology proposed under the draft Recommendation notwithstanding the clear wording of Article 8.2(c) of the Framework Directive referring to the need for NRAs to encourage “*efficient investment in infrastructure and the promotion of innovation*”. If operator margins are squeezed and operators cannot recover the costs of termination then investment in the network and in new service delivery will be reduced.

Proposed change 5: Encourage NRAs to take account of the short and long term effect on investment in their termination rate determination

3.6. The correct approach to calibrating LRIC models

The draft Recommendation paragraph (2) proposes that the evaluation of efficient costs should be based on current cost and the use of a bottom-up modelling approach using LRIC. We agree that a form of bottom-up approach is necessary for calculating the efficient cost of termination relevant for all mobile (resp. fixed) operators in a given country but it is only one side of the calculation. Paragraph (9) of the draft Recommendation states that NRAs *may* compare the results of bottom up modelling with a top down model. In the view of OFTG, it is *essential* that hypothetical current efficient cost and engineering estimations are calibrated with what is observed in the real world. Each side of the calibration serves as a sense check against the other. In the absence of reconciliation with a top-down model, theoretical bottom-up modelling could easily lead to technical errors. For instance, non-reconciled bottom-up could model network configurations that do not work in practice or network configurations that do not support all the wholesale and retail services provided by an actual network. A top down approach ensures that the final cost does reflect the cost of an operator which can exist and can deliver the services delivered by real networks.

Furthermore, OFTG is of the view that the expectation of the draft Recommendation that current costs and bottom-up models would necessarily lead to lower termination rates is misplaced.

Proposed change 6: Encourage NRAs to use and calibrate both bottom up and top down models to reach an efficient cost of termination.



3.7. Technology neutrality

The draft Recommendation states in paragraph (3) that the core part of both fixed and mobile networks should be Next-Generation-Network (NGN) based. At this early stage, OFTG provides that it would be highly speculative to estimate the cost of roll-out and functioning of this nascent technology. Moreover, it is essential to retain the principle of technology neutrality in this Recommendation to allow flexibility for Member States which are at different stages of introducing NGN technology. The network cost should be reflective of the network deployed and mobile operators should be incentivised to use the combination of the most efficient technologies available. Restricting the core network component to NGN takes away this flexibility. NGN costs should be incorporated only when relevant i.e. as and when it is the best technology to provide existing wholesale and retail services. This principle should apply equally to 2G and 3G technologies so that the NRA has the discretion to decide on the appropriate technology mix suited to the development of the individual market.

Proposed change 7: To retain the principle of technology neutrality. NRAs should be allowed to consider using NGN core network costs and 2G/3G access network costs when appropriate.



4. Conclusion

A sudden drop in MTRs which do not reflect the real cost environment will have a distortionary impact. It will distort the benefits of MTRs falling gradually over time. Firstly, an artificial sudden drop in MTRs can provoke a reactive increase in price to recover the lost revenue. Secondly, a significant number of consumers will not be able to afford mobile services.

A steady MTR reduction has been obtained by applying the principles of cost orientation enshrined in Art.13 of the Access Directive. European NRAs have translated the evolution of cost in the mobile industry into a 40% decrease in MTRs over the past four years. The European Regulators Group (ERG) members have further made a commitment to reduce mobile termination rates and expect a reduction of about 40% in the coming three years. Steady but rational and manageable MTR reductions are achievable if MTRs continue to be set according to proven LRAIC principles.

The draft Recommendation should therefore:

- Reaffirm that termination rates should be oriented towards LRAIC; and
- Determine how to apply LRAIC for the calculation of symmetric fixed termination rates between fixed domestic operators and symmetric mobile termination rates between domestic mobile operators within each Member State.

This implies the following substantial amendments to the draft Recommendation:

- Keep joint and common costs in the termination rate calculation;
- Keep both relevant coverage related and capacity related costs of termination;
- Keep all radio access costs and spectrum costs (both traffic related costs) for mobile;
- Continue to allow full costs of termination to be recovered from the termination service in accordance with Article 13 of the Access Directive;
- Encourage NRAs to take account of the short and long term effect on investment in their termination rate determination;
- Encourage NRAs to use and calibrate both bottom up and top down models to reach an efficient cost of termination; and
- Retain the principle of technology neutrality. NRAs should be allowed to consider using NGN core network costs and 2G/3G access network costs when appropriate.



Annex 1 Legal Assessment

The draft Recommendation raises a number of legal and EU constitutional issues which the France Telecom Orange Group wishes to highlight in the context of the consultation.

1. The draft Recommendation amounts to a regulation in disguise

The draft Recommendation in effect seeks to regulate termination rates in a binding manner throughout the EU. This is clear from the content of the draft Recommendation, the way it is phrased and the stated aim and purpose of the measure.

Points 10 and 11 of the draft Recommendation, impose - rather than recommend - on NRAs both a specific cost model and a fixed timetable to implement it. The draft Recommendation explicitly limits the circumstances in which an NRA may (for a limited time period) diverge from the approach mandated by the Commission. Point 11 further specifically mandates an actual level for termination rates for an interim period (between 31/12/2011 and 31/12/2013) that *“should not exceed the average of the termination rates set by NRAs implementing the recommended cost methodology”*. This approach contrasts with the aim of recommendations, which are intended only to cast light on the interpretation of national or Community law (113/75 *Frecassetti*; 90/76 *Van Ameyde*) and not to “prescribe” a *modus operandi*.

More generally, the language of the draft Recommendation contrasts with examples from the past where the wording is in line with the spirit of a true recommendation. For example, the Commission Recommendation on accounting separation and cost accounting systems under the regulatory framework for electronic communications (C(2005)3480) was adopted under Article 19 of the Framework Directive also and is closely connected to the subject matter at stake. In that Recommendation, almost every paragraph in the operative part of the Recommendation that is directed to NRAs starts with the formulation *“[i]t is recommended that”*, whereas this formulation is rarely used in the operative part of the draft Recommendation. Instead, the draft Recommendation imposes a cost model and/or a price benchmark (during an interim period) for NRAs that should be applied by the target date that is defined therein.

The binding nature of the targeted termination rate reduction is also corroborated by the object and purpose of the measure underlined by the Commission’s statements at the initiation of the consultations on the draft Recommendation. These statements raise the expectation of a pre-defined average reduction of (mobile) termination rates irrespective of NRA analyses. More specifically, on 26 June 2008 Commissioner Reding stated:

“Over the next 3 years, I expect greater consistency and coordination to bring the costs for mobile phone calls down by around 70 per cent from the current level.”



According to ECJ case law, recommendations are “*measures which, even as regards the persons to whom they are addressed, are not intended to produce legal effects*” and “*generally adopted by the institutions of the Community when they do not have the power under the EC Treaty to adopt binding measures*” (Case C-322/88, *Grimaldi*). It also follows from settled ECJ case law that “*the choice of form cannot alter the nature of a measure*”, so that it must be ascertained whether the content of the measure is wholly consistent with its form (see Case 147/83, *Binderer*). Whether a Community act is a binding measure primarily depends on its aim and content, not on the official title conferred on it by the Commission.

In the present case, the so-called Recommendation, in effect seeks to regulate termination rates at a certain price level. The proposed Recommendation therefore actually amounts to a binding measure which falls outside the competence of the Commission as organized in the EU Regulatory Framework and in Article 19(1) of the Framework Directive in particular (see hereafter).

2. The draft Recommendation exceeds the boundaries of the Commission’s powers under Article 19 of the Framework Directive

The legal basis for the draft Recommendation is Article 19(1) of the Framework Directive which states that:

“[w]here the Commission, acting in accordance with the procedure referred to in Article 22(2), issues recommendations to Member States on the harmonised application of the provisions in this Directive and the Specific Directives in order to further the achievement of the objectives set out in Article 8, Member States shall ensure that national regulatory authorities take the utmost account of those recommendations in carrying out their tasks. Where a national regulatory authority chooses not to follow a recommendation, it shall inform the Commission giving the reasoning for its position.”

The draft Recommendation goes beyond the harmonisation objective of Article 19 of the Framework Directive however as it seeks to bypass the NRAs’ competences not only by seeking to limit their ability to deviate from recommended practices (see above) but also, and even more fundamentally, by regulating an area that, in the general scheme of the EU Regulatory Framework, has been reserved to the Member States, thus violating the principle of allocation of competences and subsidiarity enshrined in Article 5 EC Treaty.

The draft Recommendation also specifically fails to respect the boundaries imposed by Article 19(1) of the Framework Directive. As mentioned before, Article 19(1) allows for NRAs to diverge from a recommendation, provided they inform the Commission and give reasons for their position. This possibility is being curtailed by the draft Recommendation, however, even though the possibility for divergence of Article 19 should always prevail over the Commission’s recommendations.

By imposing a particular cost model (irrespective of the merits of such model), the draft Recommendation further undermines the successful functioning of the Article 7 mechanism and violates the NRAs’ competences to conduct market analyses and mandate, where appropriate, a



“cost recovery mechanism or pricing methodology” under Article 13 of the Access Directive. As a result, NRAs would no longer be in a position to take the necessary measures relating to termination rates in their own Member States autonomously, nor to tailor them to the specific characteristics of their national markets.

The Article 7 mechanism does not provide the power to the Commission to veto remedies that would be imposed by NRAs. In fact, the enlargement of such competence (allowing the Commission to veto also remedies imposed) is one of the specific issues of the on-going legislative review through the co-decision procedure between Parliament and Member States. Surely, if the Commission cannot veto but only comment remedies imposed by NRAs under current legislation, it cannot impose a specific form of price remedy (*in casu* a cost model or a specific price decrease) via a recommendation under Article 19(1) that would undermine the current repartition of competences between the Commission and NRAs.

Beyond the undermining of the Article 7 process, the substantive choices made in the draft Recommendation as regards cost models also disregard an extensive body of existing NRA practices and national court rulings that have addressed in great detail issues relating to MTRs in general, and cost recovery mechanisms and pricing methodology in particular. This is contrary to the Commission’s duty of sincere cooperation with the Member States, as the Commission must duly consider national decisions in this area also (Article 10 EC Treaty – Case 203/81, *Luxembourg v European Parliament* and Case C-319/97, *Kortas*). It also runs against the spirit of Article 8(3) of the Framework Directive which states that NRAs are required to contribute to the development of the internal market by “*co-operating with each other and with the Commission in a transparent manner to ensure the development of consistent regulatory practice and the consistent application of [the Directives of the Regulatory Framework]*”.

In *Arcor* (Case C-55/06), Advocate-General Maduro highlighted that “[w]here the Community legislature has not given any precise guidance regarding cost elements or the cost calculation methods or models to be used [...] the regulation leaves the Member States an inevitable margin of discretion in implementing this concept. That degree of latitude will, primarily, allow the national legislatures to determine which elements of [...] provider’s particular costs are to be taken into account and, in particular, to define the relevant costs of the notified operator as being limited to the costs of providing an efficient service, as well as to define the methods and models to be used to calculate the costs connected with providing [...]”.¹³ Even if the *Arcor*-case relates to a different regulation, the holding is fully applicable to the context at hand where Article 13 of the Access Directive also does not command a specific cost methodology. It is precisely this margin of discretion left to the NRAs which the draft Recommendation disregards completely.

¹³ The Court confirmed the Advocate General’s view when stating that “it is apparent from Article 4(1) and (2) of Regulation No 2887/2000 that, when examining the rates of notified operators for the provision of unbundled access to their local loop in light of the pricing principle laid down in Article 3(3) of that regulation, the NRAs have a broad discretion concerning the assessment of the various aspects of those tariffs, including the discretion to change prices, and thus the proposed tariffs.” On the degree of discretion of NRAs when setting charge caps, see also *Mobistar v IBPT* (Case C-438/04), para. 34.



3. The draft Recommendation is incompatible with Article 13 of the Access Directive as it misapplies the concepts of excessive pricing and cost orientation

a) Excessive pricing

The draft Recommendation is based on the notion that “*the main potential competition concern common to both fixed and mobile termination markets is that of excessive pricing, implying that operators may extract excessive profits at the wholesale level*” (see Explanatory Note, page 6).

The Commission believes (without any analytical support for its position) that mobile termination rates are excessively high in the EU, notably when compared to fixed termination rates and mobile termination rates in other countries (see recital 3 of the draft Recommendation). In doing so, it ignores the work of NRAs, which has resulted in a 40% decrease for mobile termination rates in the past four years, and disregards the fact that Article 13 of the Access Directive provides that it is for NRAs to determine, based on a market analysis, whether price levels may be excessive. It further ignores its own explanation for the difference between fixed and mobile termination rates that is set out in the draft Explanatory Note (page 6, last paragraph).

More fundamentally, however, the draft Recommendation is at odds with the notion of excessive prices developed in the Community Courts’ case law under Article 82 EC Treaty.

First, excessive pricing cannot be established “*on the basis of a simple comparison of the level of charges*” in different countries (Case T-306/05, *Scippacercola and Terezakis v Commission* (Athens Airport case). Accordingly, the fact that mobile termination rates are currently at “*disparate levels across different Member States*” (see MEMO/08/438) is not a sufficient ground to conclude to the existence of excessive prices - *a fortiori* regulated prices -, contrary to what the Commission suggests. Furthermore, the example of mobile termination rates in Cyprus and Bulgaria (both outliers in the EU mobile termination rates) can hardly be referred to as being representative for the mobile termination rates in the EU. In fact, leaving the outliers aside, mobile termination rates vary between 5.28c (in Finland) and 11.63c (in Poland).¹⁴

Second, the appropriate measure of cost in excessive pricing cases is the “*total cost of production*” (Case 27/76, *United Brands*). This implies that all costs that are relevant should be taken into account.

The draft Recommendation’s approach, which imposes the “avoidable cost” concept runs contrary to this case law. Indeed, we understand that the “avoidable cost” concept would result in the exclusion of a whole range of costs among which:

- common costs (see recital 14),
- coverage costs (see Annex to the draft Recommendation),
- spectrum costs (see Annex to the draft Recommendation),

¹⁴ See ERG (08) 17 MTR update snapshot final 080604.



- joint costs (see recital 13),
- “costs that do not vary in response to an increase in wholesale termination traffic” (see draft Explanatory Note, page 15).

Some of these excluded cost categories overlap with each other. Yet, as recognised by the draft Explanatory Note, joint costs and common costs represent the majority of costs of the telecommunications sector (see pages 13-14). Therefore, the exclusion of costs listed above is material.

b) Cost orientation

The draft Recommendation also misapplies the concept of cost orientation. In effect, the cost model which it seeks to impose on NRAs and operators amounts to “below cost orientation”.

As mentioned above, the draft Recommendation does not allow for coverage of joint and common costs which represent the majority of costs in the telecommunications sector. In addition, unlike fixed telephony where the costs of the local loop (access network) are recovered from subscription fees (see page 6 of the draft Explanatory Note),¹⁵ the access part of the mobile networks (radio access network, i.e. base stations and associated equipments) are not covered by subscription fees but through mobile termination charges. Still, the draft Recommendation proposes to remove a large proportion of these costs from the mobile termination rates (see p. 23 of the draft Explanatory Note) notably by excluding the coverage costs.

The draft Recommendation suggests to rebalance these excluded costs to the calling party, in view of the two sides nature of call termination (see page 15 of the draft Explanatory Note). According to the draft Recommendation, however, the recommended cost model should benefit end-users in terms of lower retail prices (see recital 7, last sentence). The suggested rebalancing would therefore not affect retail price reductions. By implication, it would also not allow for the recovery of excluded costs.

Thus, whilst the Commission claims that the draft Recommendation’s costing model allows for adequate cost coverage, it implicitly acknowledges the contrary as, on the one hand, it excludes a whole range of actual costs currently included in the mobile termination rates, and, on the other hand, it does not truly envisage such costs being recovered elsewhere as the recommended model is supposedly leading to retail price reductions. Accordingly, the draft Recommendation goes beyond the principle of cost orientation enshrined in Article 13 of the Access Directive.

ECJ case law on the concept of cost orientation further confirms that the draft Recommendation is inconsistent with the remedy of Article 13 of the Access Directive.¹⁶

¹⁵ As mentioned in the draft Explanatory Note: “*The regulatory model underlying the FTR regulation assumes that operators will recover the cost of the local loop via retail subscription charges, and that these costs are not paid included in the FTR paid by other operators, including mobile operators.*”

¹⁶ In *KPN Telecom v OPTA* (Case C-109/03) and *Commission v France* (Case C-146/00), the ECJ has recognised that the cost orientation requirement allows to cover all relevant costs.



Most recently, in *Arcor v Germany* (Case C-152/07), the ECJ confirmed that “*due regard*” should be paid “*to the principle of the cost orientation of tariffs*” and that this principle “*requires that charges be derived from actual costs*”. In *Arcor v Germany* (Case C-55/06), the ECJ also looked extensively into the concept of cost orientation and held, *inter alia*, that in applying the principle of cost orientation, “*the NRAs have to take account of actual costs, namely costs already paid by the ... operator and forward-looking costs, the latter being based, where relevant, on an estimation of the costs of replacing the network or certain parts of it*”.

The approach of the draft Recommendation is thus also contrary to the concept of cost orientation as interpreted by the ECJ case law.
