



European Commission

Public consultation on termination rates

Submission by Portugal Telecom, S.A.



GENERAL COMMENTS

In this draft Recommendation project, the only European Commission decision PT finds positive is the one regarding the goal of making call termination prices symmetric across fixed and mobile lines.

Regarding all other EC intentions concerning the control of these prices, we cannot help but express a deep concern about how this control is to be exerted: through the imposition of a specific cost model for call termination services (LRIC model of a bottom-up approach). Moreover, we find that these intentions are based on inadequate theoretical presuppositions which are out of touch with reality.

PT believes that this draft Recommendation does not properly provide the necessary conditions to ensure the sustainability of investments made in infrastructures and of an appropriate return on applied capital. As a result, access to financing sources is bound to be tighter.

Since the telecommunications sector is characterised by rapid technological evolution and requires high levels of investment, investors in the capital market increasingly want to safeguard the money they put into this sector. This attitude leads them to opt for stable and somewhat more predictable regulatory environments.

With this in mind, the fact that the NRA (National Regulatory Authority) may have full control over fixing a price in cases where possibly it is granted the right to arbitrarily disallow the inclusion of certain costs (thus blocking operators from remunerating invested capital) may compromise operators' access to sources of capital and significantly reduce their capacity to invest which would, in time, progressively compromise their viability.

PT believes that the EC, by trying to find a drastic solution to a question that is still in need of sensible analysis and a balanced decision regarding its timing, has opted for a solution which is as awkward as it is particular, in contradiction with the cost accounting methodologies in use and that breaks the unity of the cost imputation rules used in the global cost models based on ABC methodologies.

It is our belief that placing a particular issue above a global perspective and imposing a solution which leads to a predetermined result for a certain service instead of respecting the internal coherence of the global models which determine the costs of all services will result in a proposal which, instead of solving the problem at hand (an imbalance between termination

fees), will create a faulty solution of grave consequences and bring about a situation more troubling and unsustainable than the one it sets out to solve.

SPECIFIC COMMENTS

- 1) In line with the ERG's common position on call termination rates, PT believes that if these prices are uneven, this will cause distortions in the market, harming economic welfare.

Accordingly, PT agrees with the principle put forth in the EC's draft Recommendation that termination rates should tend to be symmetric as a means to promote market efficiency. Additionally, future imbalances must be accepted only in duly justified and exceptional circumstances, and for a limited and transient period of time.

These considerations do not depend on how fixed and mobile call termination rates are currently set. The introduction of symmetric call termination rates should not be conditioned by the transition deadline included in EC's Recommendation for NRAs to implement a LRIC cost model.

On this subject, we would also like to express our agreement with the fact that an entrant cannot benefit from establishing asymmetries in termination rates — item (8) in the Recommendation.

- 2) PT acknowledges that the ultimate goal of regulation is to create better and less costly conditions of access and for telecommunications services for end consumers. PT believes that a competitive market is a basic condition for ensuring that operators make a more efficient use of resources, without which there cannot effectively exist a policy for securing low cost services.

PT is also aware that a boost in efficiency is closely connected with the development of new technologies and services, as well as the modernisation and rationalisation of business processes. However, these developments require high levels of investment, and conditions allowing for the proper repayment of invested capital must be secured. Otherwise access to funding may become restricted and the required investment capacity will drop significantly.

PT agrees that, in theory, a LRIC model is a credible method for translating the costs that an efficient operator has. Namely because it not only means that operators will carry out an important re-evaluation of its assets' value and that the useful life of equipment and

infrastructures will undergo careful analysis, but also that it requires an exhaustive definition of the nature and dimension of the joint and common costs to be considered in the mark-up. PT also considers that the cost established under these models is of the type of an objective-value, corresponding to the lower limit of the band where the price must be set.

There are, however, some problems regarding the reliability of this theoretical model when materialized in a bottom-up approach, which may compromise its use.

The quality of a bottom-up model is significantly determined by the volume, quality and depth of the chosen theoretical presuppositions. Its results may turn out to be completely out of touch with the operators' economic reality.

In fact, the possible theoretical merit of such an approach can be easily countered, when applied to real situations, by the adoption of solutions which oversimplify and lead to formulas that ignore certain components of relevant costs and that may result in seriously distorting results. In this regard, the concepts of efficiency and technological adjustment must be approached with utter care.

On the other hand, if the approach is based on a instantaneous vision of the network that only includes the present, the historic facts which led up to its construction and development will be overlooked, as well as the need to take into account the time frames of the cycles of incurred investment.

Given how critical this issue is, it is essential that the development of cost methodologies is made in a gradual and consolidated manner, so as to prevent weighty disruptions. As for the rest, fears induced by the imperfections and gaps that result from a bottom-up model are reflected in item (9) of the draft Recommendation where it is predicted that the results of this model are compared and checked against a top-down model.

We favour a top-down approach in collaboration with national network operators, which would allow to explore and clarify basic issues such as the normalisation of fixed assets' useful life periods, the cost assessment methodology for establishing the current cost of assets, depreciation and amortization criteria and the definition of efficient solutions (which do not necessarily have to be the most modern). As a whole, these points bear a decisive weight on assessing costs. Such a clarification would create a more rational framework to help make decisions regarding the mark-up and the remuneration of investment. The success of this approach would surely allow to create optimal conditions for bordering on new methods within a reasonable time limit.

- 3) Instead, the solution currently being put forth is radical, since its goal seems to be solely that of establishing grounds from which to impose very low prices, instead of aiming to promote a more balanced and equitable framework to remunerate this service.

By choosing to impose a bottom-up model based on predefined technologies (i.e., the network's core, fixed or mobile, must be based on an NGN and mobile network access on an optimised 2G and 3G combination, yet to be established) - the nationwide implementation of which still does not have a set timeline and will possibly be carried out in stages -, there is a risk of distorting the operators' realities, a risk of unforeseeable consequences when it comes to assessing costs.

A cost model whose results allow decisions that promote the efficiency of a given market must take into account the technology which is used by the operators in each country and the circumstances which have led to its implementation.

PT thus believes that the Recommendation should abstain from opting for specific technologies or network architectures. Instead, the EC should grant the NRAs the liberty to define - jointly with national network operators and in function of each country's specific reality - what technologies and architectures best suit which type of model.

Additionally, a centralised imposition of an NGN architecture to set up the bottom-up model, as proposed by the EC, does not match the principle of technological neutrality which should guide any regulatory intervention.

- 4) and 5) Regarding the LRIC method, incremental costs are those which are directly or indirectly related with a given service and may be avoided if that service is not provided.

Moreover, whichever cost model is applied, one must always keep the recovery of the operators' joint and common costs in mind, without which their financial viability is undermined.

The EC's draft Recommendation supports a large reduction in costs, stemming from what appears to be the intent to disregard any mark-up which allows to cover joint and common costs, especially since it is known that from a TSLRIC (Total Service Long Run Incremental Cost) perspective applied to a sole specific service, the weight of the joint costs is significant given the high level of resource sharing in network traffic and core.

This solution leaves out a significant set of costs which are required to bring about a service. This creates an unacceptable situation both in terms of cost imputation as well as at a company economy level.

The EC seems excessively fixated on guaranteeing extremely low call termination rates, even if this means that - by omitting joint and common costs - prices are set below cost. Notwithstanding, in order to secure the long-term solvency of the companies, the costs which are thus not recovered shall have to be built into other services, namely retail services. This will undoubtedly result in less efficient balances in the market.

Such an approach only makes sense when it comes to establishing a company's tariff policy, in which case the company should have the flexibility to recover its joint and common costs through the various services it provides (or various groups of clients). Therefore, and if it is a company with SMP declared in the given market(s), it should only be required to (for each product) charge a price that can cover the variable, incremental or avoidable cost of providing this product. That is, the incremental cost, without any mark-up, can be used as a cost standard to ascertain whether there is an occurrence of predatory pricing.

In terms of setting a regulated price, such an approach is totally out of place, since the regulator must harmonise the goal of promoting competition with that of recovering the costs (including common costs) taken on by the operator. The regulated company should not be forced to retrieve those costs through other means, which would push it into cross-subsidisation.

It is important to note that common costs are compatible with efficiency; what may be up for discussion is the level of common costs that corresponds to an efficient operator.

As a result, PT believes it is essential that the implementation of the LRIC method is carried out together with a mark-up that enables operators to recover common costs. This approach was also defended by the IRG in 2000 in its 'Principles of implementation and best practice regarding FL-LRIC cost modelling' document.¹

Additionally, the EC seems to focus on network costs when it comes to the issue of eligibility of costs regarding the wholesale call termination service. To that effect it establishes a distinction between traffic and non-traffic related costs, and then only retains those which are incremental (residual, in the EC's sense).

¹ PIB VII – *The NRA will have to keep in mind, when using LRIC information for regulatory purposes, that an appropriate recovery of a reasonable proportion of common costs is necessary.*

However, there are non-network related costs which turn out to be incremental in relation to the call termination service. For example, certain invoicing and debt collection costs come about due to the fact that a wholesale call termination service exists and are, therefore, avoidable, incremental. Hence, we cannot agree with the EC's proposal, which seems to want to reduce incremental costs of the call termination service to traffic-related residual costs.

In respect of defining and calculating the increment, the adoption of differentials between the costs of an operator that provides an offer which includes all of its services and one providing an offer which does not include a call termination service bears a different impact on the network's size and architecture. A theoretical framing of both situations has to be undertaken so as to protect the total recovery of the investments made by the operators. The complexity of this undertaking leads back to the comments included in the previous item regarding the need for NRAs to choose their model in close co-operation with network operators.

- 6) Concerning the implementation of the LRIC method, assets should be valued according to current costs. This value should be calculated according to the depreciation methods used in accounting. The useful life of assets should also be subject to revision, if deemed appropriate.

We would then be closer to the implementation of economic depreciation. Notwithstanding, a methodology which guarantees the full recovery of investments made should always be used if the value of current costs is lower than the book value.

- 7) We believe that the method which has been proposed to determine mobile operators' efficient scale is too simplistic, completely broken off from reality and lacking economic grounds. Adopting this method means presupposing that for a market to be efficient, the market share of the various operators must be the same. This is unrealistic; on top of that, market efficiency depends on countless factors beyond mere market share.
- 8) PT agrees with the principle that differences in costs whose nature is beyond the control of operators should be included in the cost model.

- 9) Taking into account the weaknesses pointed out to the bottom-up model, and since we believe that it would be more appropriate for operators to adopt the top-down model, a comparison of both models is crucial in order that reliable and quality results can be attained.

One should overlook the fact that a telecommunications operator requires heavy investments and a considerable use of resources to implement and make a cost model operational. The existence of several cost systems, calculated according to different methods, would not be sustainable.

PT is therefore of the understanding that if a bottom-up model (theoretical model) is to be implemented and put into operation, the NRAs should be responsible for its implementation, and the operators for implementing a top-down model so as to compare results.

- 10) The regulatory entities may establish an efficient call termination price based on the cost model, provided that it duly reflects the given market, its evolution, dimension, and the investments to be made or already made by the various operators. Disregarding these factors may undermine the operators' competitiveness and their long-term offer, especially in a sector such as that of electronic communications, which requires intensive investment in development and updates.

Regarding symmetry, this should always be maintained regardless of the level of fees. Moreover, as we have mentioned in item 1), it should not be dependant on the transition deadlines included in the Recommendation.

- 11) Given the insufficiencies and difficulties which might affect the development of a bottom-up model, PT agrees that the possibility of the NRAs being able to establish a different methodology (one which, given the specific circumstances of each country, turns out to be the most appropriate), should be kept open.

In this sense, we would like to underline that, in terms of establishing call termination rates, the results obtained from the cost model must adequately reflect the factors surrounding the reality of the operator in each country.



Finally, we do not believe that it is correct to limit the results obtained through a method other than the LRIC method to a maximum of the average of the call termination costs obtained by the NRAs which implement the cost model proposed by the EC. We are of the opinion that this may lead to considerable distortions and pervert the goals of efficiency this Recommendation wishes to attain.