

EUROPEAN
COMMISSION

Brussels, 19.6.2018
C(2018) 3722 final

COMMISSION RECOMMENDATION

of 19.6.2018

in accordance with Article 7a of Directive 2002/21/EC of the European Parliament and of the Council of 7 March 2002 on a common regulatory framework for electronic communications networks and services ("Framework Directive") in Case SK/2018/2051: Wholesale voice call termination on individual public telephone networks provided at a fixed location in Slovakia

Only the Slovak version is authentic

COMMISSION RECOMMENDATION

of 19.6.2018

in accordance with Article 7a of Directive 2002/21/EC of the European Parliament and of the Council of 7 March 2002 on a common regulatory framework for electronic communications networks and services ("Framework Directive") in Case SK/2018/2051: Wholesale voice call termination on individual public telephone networks provided at a fixed location in Slovakia

Only the Slovak version is authentic

THE EUROPEAN COMMISSION,

Having regard to the Treaty on the Functioning of the European Union,

Having regard to Directive 2002/21/EC of the European Parliament and of the Council of 7 March 2002 on a common regulatory framework for electronic communications networks and services (Framework Directive)¹ and in particular Article 7a (5) thereof,

Having called on interested parties to submit their observations² pursuant to the provision cited above and having regard to their observations,

Whereas:

1. PROCEDURE

- (1) On 22 January 2018, the Commission registered a notification from the Slovak national regulatory authority, Úrad pre reguláciu elektronických komunikácií a poštových služieb (RÚ)³, concerning termination rates in the market for wholesale call termination on individual public telephone networks provided at a fixed location (the notified draft measure).
- (2) On 31 January 2018, a request for information (RFI)⁴ was sent to RÚ and a response was received on 5 February 2018. On 5 February 2018, a supplementary RFI was sent to RÚ, and a response was received on 6 February 2018. On 6 February 2018, a second supplementary RFI was sent to RÚ, and a response was received on 7 February 2018.
- (3) On 21 February 2018, the Commission, pursuant to Article 7a(1) of the Framework Directive, initiated a Phase II investigation and subsequently notified RÚ and BEREC

¹ Directive 2002/21/EC of the European Parliament and of the Council of 7 March 2002 on a common regulatory framework for electronic communications networks and services (Framework Directive), OJ L 108, 24.4.2002, p. 33, as amended by Directive 2009/140/EC, OJ L 337, 18.12.2009, p. 37, and Regulation (EC) No 544/2009, OJ L 167, 29.6.2009, p. 12.

² Notice published at: <https://circabc.europa.eu/webdav/CircaBC/CONNECT/e-cctf/Library/02%20-%20Second%20Phase%20-%20Invitation%20to%20submit%20observations/Web%20notice%20to%20third%20parties%20SK-2018-2051.pdf>.

³ Under Article 7 of the Framework Directive.

⁴ In accordance with Article 5(2) of the Framework Directive.

of the reasons why it had serious doubts as to the compatibility of the notified draft measure with EU law (the serious doubts letter).

- (4) On 4 April 2018, BEREC delivered its opinion to the Commission⁵ and fully supported the Commission's serious doubts.

2. DESCRIPTION OF THE NOTIFIED DRAFT MEASURE

2.1 Previous notifications

- (5) The fourth review of the fixed termination markets was notified to and assessed by the Commission under case SK/2016/1955⁶.

- (6) RÚ proposed to include in the market definition the termination of calls in the fixed network on geographic numbers of end users regardless of where the call was originated. RÚ included in the product market definition the wholesale services of call termination on public telephone networks at a fixed location provided either by traditional PSTN networks, optical networks, cable (CATV) networks, wireless FWA/WiFi networks or mobile networks if the end users' services mobility was limited. In this respect, RÚ included into the product market definition Home/Corporate lines provided by Orange Slovensko. RÚ considered that the geographic scope of the market corresponded to the coverage area of the respective operator's network in the territory of Slovakia.

- (7) RÚ proposed to designate 17 undertakings⁷ with SMP, and imposed on them the following remedies: (i) access to specific network facilities, (ii) non-discrimination, (iii) transparency, and (iv) price control based on a pure BU-LRIC cost methodology. In line with the previous market analysis, the termination of calls originated outside the EU/EEA was excluded from the price control obligation. The Commission had no comments.

2.2 The notified draft measure

- (8) The notified draft measure concerns the proposal to set symmetric price caps for voice call termination on individual fixed networks (FTRs) of EUR 0.000976 per minute on the 17 SMP operators⁸.

- (9) In order to set the FTRs for the fixed operators, RÚ applies a BU-LRIC model assuming a network of a hypothetical efficient operator, entering the market today.

- (10) In the context of the calculation of FTRs through the BU-LRIC model, RÚ also assesses the Weighted Average Cost of Capital (WACC) and proposes to set it at the level of 5.21% but adjusting the gearing for a hypothetical efficient operator.

- (11) RÚ calculates the cost of equity using the capital asset valuation model:

$$Re = Rf + \beta * (Rm - Rf) + SP^9$$

⁵ In accordance with Article 7a(3) of the Framework Directive.

⁶ C(2016) 8842 final.

⁷ Slovak Telekom, BENESTRA, Slovanet, Orange Slovensko, IPfon, Swan, ŽSR ŽT, UPC, VM Telecom, DH Telecom, ANTIK, DIALOGA, Digitale, O2 Slovakia, Phoonio, UAB "Raystorm", and VNET.

⁸ In line with the previous market analysis, the termination of calls originated outside the EU/EEA is excluded from the price control obligation.

⁹ Where Re stands for the cost of equity, Rf is the risk-free rate, β is the equity beta and Rm is the average return on the market portfolio. "SP" is a "business size surcharge" or "size premium" published annually, according to a study by Duff & Phelps: Valuation Handbook.

- (12) According to RÚ, the addition of a size premium (SP) would reflect the risk of the variability in the return of the operators' shares in the long run perspective depending on the size of undertakings, according to the study mentioned, and which is derived from the market capitalization of the companies listed in the US stock exchange. This mark-up corresponds to ■ percentage points. It was unclear from the notification and from the responses to the RFIs how RÚ derived a ■ percentage points mark-up on the WACC and its justification. Regarding the equity beta, RÚ used a beta value of ■ resulting from data on a peer group of EU fixed network operators reported by Bloomberg¹⁰.

3. SERIOUS DOUBTS EXPRESSED BY THE COMMISSION WHEN INITIATING THE SECOND PHASE OF THE ARTICLE 7a PROCEDURE

- (13) On 21 February 2018, the Commission expressed serious doubts as to the compatibility with EU law of RÚ's notified draft measures, in particular with the need to ensure that customers derive maximum benefits in terms of efficient cost-based termination rates and that fixed termination rates promote competition; i.e. the requirements referred to in Articles 8(4) and 13(2) of the Access Directive¹¹ in conjunction with Article 8 of the Framework Directive and Article 16(4) of the Framework Directive.

3.1. Mark-up for company size in the WACC calculations

Compliance with Article 8(2)(a) and 8(5)(d) of the Framework Directive

- (14) The Commission referred to Article 8(2)(a) and 8(5)(d) of the Framework Directive as well as Articles 13(1) and (2) of the Access Directive that require NRAs to impose a cost control obligation aimed at achieving, among other, the objectives of (i) encouraging efficient investments, including in next generation networks, and (ii) allowing a reasonable rate of return on adequate capital employed, while promoting efficiency and sustainable competition and maximising consumer benefits in terms of choice, price and quality. Moreover, the Commission referred to Article 8(5)(d) of the Framework Directive which sets out that NRAs shall promote efficient investment and innovation, whilst ensuring that competition in the market is preserved.
- (15) Since the weighted average cost of capital is a component of a cost-oriented price to be applied by SMP operators in the market at stake, NRAs are bound by these provisions in calculating the WACC value.
- (16) Regarding the WACC calculation, the Commission expressed serious doubts that the notified WACC value would actually reflect the currently prevailing competitive conditions, in both the relevant and the capital markets in Slovakia, taking into account the risk incurred by the investing undertakings, and contribute to the required robustness regarding the relevant parameter used to set the cost-oriented prices of the SMP operators (in this case of FTRs).
- (17) Specifically, the Commission noted that RÚ calculates the cost of equity applying a mark-up ("Size premium") which would reflect the risk of the variability in the return of the operators' shares in the long run perspective depending on the size of

¹⁰ In particular, RÚ used values that adjust the estimated beta towards 1, based on the general assumption that betas have a long-term tendency to converge towards 1.

¹¹ Directive 2002/19/EC of the European Parliament and the Council of 7 March 2002 on access to, and interconnection, of electronic communications networks and associated facilities, OJ L 108, 24.4.2002, p. 7 (of the Access Directive).

undertakings, defined according to the study by Duff & Phelps: Valuation Handbook, and which is derived from the market capitalization of the companies listed in the US stock exchange.

- (18) Such mark-up corresponds to ■■■ percentage points and would lead to an increase of approximately ■■■% of the nominal pre-tax WACC point estimate for fixed markets (resulting in a pre-tax WACC of 5.21%).
- (19) RÚ explained that it essentially adds a mark-up to the WACC formula to compensate for the relatively smaller size and "higher risk" of the Slovak operators compared to the other operators from Member States included in the peer group that was used to calculate the equity beta. RÚ argued that since the Slovak operators are smaller, the investors would encounter higher risks and a mark-up should therefore be added to the usual WACC formula.
- (20) The Commission did not share RÚ's position considering that i) in contrast to what was claimed by RÚ, such mark-up for size is not commonly applied by other NRAs in the EU and does not constitute a "common regulatory practice" and ii) the justification for the size premium provided by RÚ is not sufficient. The Commission recalled that the traditional parameters of the WACC formula (the size premium is not one of them) should be able to fully account for the non-diversifiable risk of the companies, including the risk of Slovak companies. Any additional diversifiable (i.e. non-systemic) risk associated with investing in Slovak companies could in theory be "diversified away" by investing in companies in other countries or in other industries.
- (21) RÚ seemed to have captured the inherent non-diversifiable risk of the Slovak operators already in the following ways:
 - (a) the use of Slovak government bonds to determine the risk-free rate;
 - (b) taking into account the gearing ($\text{DebtValue}/(\text{DebtValue}+\text{EquityValue})$) of the Slovak regulated companies in the overall gearing value.
- (22) In addition to that it would appear more appropriate for RÚ to have calculated the equity beta of the Slovak regulated companies, rather than using a peer group, in order to capture company specific risks.
- (23) Additionally, RÚ did not provide sufficient information on how it reaches the value of the size premium of ■■■ percentage points.
- (24) In light of the above and in absence of any valid justification provided by RÚ, the Commission considered that the mark-up should not be included in the WACC calculation as it would lead to an overestimation of the cost of equity which is likely to have a significant impact on the final value of the WACC and, correspondingly, the FTRs. Based on this the Commission's serious doubts letter concluded that the WACC value proposed by RÚ, which includes an unjustified size premium, fails to promote efficient investment and innovation, and does not ensure that competition in the market is preserved and that consumers have the maximum benefit in terms of choice, price, and quality.

3.2. Conclusions provided in the letter of serious doubts

- (25) In conclusion, the Commission expressed serious doubts that RÚ's notification provides an adequate justification of whether the proposed approach for the calculation of the WACC meets the policy objectives and regulatory principles enshrined in Article 8(2)(a) and 8(5)(d) of the Framework Directive and therefore complies with Article 13(1) and (2) of the Access Directive.

4. OBSERVATIONS SUBMITTED BY THIRD PARTIES

- (26) The Commission did not receive any comments from third parties concerning the case.

5. PROCEDURE FOR CONSISTENT APPLICATION OF REMEDIES

5.1. BEREC's Opinion

- (27) On 5 December 2017, BEREC issued an opinion with regards to the Commission's letter of serious doubts pursuant to Article 7a(3) of the Framework Directive.
- (28) BEREC considers that all the Commission's serious doubts are justified. BEREC finds that:
- (1) National regulators in the EU do not commonly apply a size premium in WACC calculations;
 - (2) There is no evidence to support the inclusion of a size premium when calculating the WACC using the capital asset pricing model (CAPM) to derive the cost of equity¹²;
 - (3) The conventional application of the CAPM should be able to appropriately capture the non-diversifiable risk associated with the regulated Slovak company;
 - (4) Some non-diversifiable risk is already incorporated since RÚ used Slovak government bonds to calculate the risk free rate, taking into account the gearing of the Slovak regulated companies in the overall gearing value;
 - (5) RÚ did not sufficiently explain why it is appropriate to derive the value of the size premium applicable to Slovak companies from a table published in the Duff & Phelps 2017 Valuation Handbook which uses information on US companies;
 - (6) The absence of serious doubts in previous notifications, in which RÚ applied a size premium, does not justify the inclusion of a size premium in this notification.
- (29) Therefore, BEREC agrees with the Commission that the inclusion of a size premium is not sufficiently justified.

5.2. Close co-operation between RÚ, BEREC and the Commission

- (30) The Commission considers that RÚ did not provide any additional justification during this co-operation phase as to how the notified measure (i.e. the methodology for calculating the WACC) could be compliant with Article 8(2)(a) and 8(5)(d) of the Framework Directive and therefore comply with Article 13(1) and (2) of the Access Directive.
- (31) At the end of the three month period following the Commission's notification of its serious doubts to RÚ and BEREC, RÚ did not amend or withdraw its draft measure.

¹² According to BEREC, while RÚ referenced some literature that supports a size premium adjustment, other literature indicates that evidence for the existence and magnitude of a size premium has weakened earlier research.

5.3. Conclusion of the procedure opened to ensure the consistent application of the remedies

- (32) Since RÚ maintained its notified draft measure at the end of the three months period following the Commission's notification of its serious doubts in accordance with Article 7a(1) of the Framework Directive, the Commission, taking utmost account of the opinion of BEREC, may issue a recommendation requiring RÚ to amend or withdraw the notified draft measure or may take a decision to lift its reservations indicated in the letter of serious doubts.
- (33) The Commission considers that the reservations expressed in its serious doubts letter remain valid.

Compliance with Article 8(2)(a) and 8(5)(d) of the Framework Directive in conjunction with Articles 13(1) and (2) of the Access Directive

- (34) The weighted average cost of capital is a component of a cost-oriented price to be applied by SMP operators in the market at stake. The Commission recalls that NRAs are bound, pursuant to Article 8 of the Framework Directive as well as Articles 13(1) and (2) of the Access Directive, to impose a cost control obligation that meets the objectives of encouraging efficient investments, including in next generation networks, and allowing a reasonable rate of return on adequate capital employed, while promoting efficiency and sustainable competition and maximising consumer benefits in terms of choice, price and quality.
- (35) In particular, Article 8(5)(d) of the Framework Directive stipulates that NRAs shall promote efficient investment and innovation, whilst ensuring that competition in the market is preserved.

Inconsistency between the CAPM framework and the use of a size premium

- (36) The Commission considers that, from a methodological point of view, the addition of a mark-up for company size is not consistent with the framework typically used by NRAs to estimate the WACC, namely, the capital asset pricing model¹³. In contrast, in line with BEREC's opinion, other parameters considered within the CAPM's WACC formula, such as the equity beta, should be able to fully account for the non-diversifiable risk of the companies considered, including the risk of Slovak companies. Any additional diversifiable risk associated with investing in telecoms companies in Slovakia could in theory be "diversified away" by investing in companies in other countries or in other industries.
- (37) The Commission therefore considers that, when calculating the cost of equity, it is not justified to apply a mark-up which would reflect the additional risk associated with the greater variability in the long-term return of an operator's shares due to the (allegedly smaller) size of that undertaking ("size premium"). In fact, the Commission takes the view that such a mark-up is liable to result in an overestimation of the cost of equity, which in turn is likely to significantly impact the final value of the WACC and, correspondingly, the prices of the relevant regulated products.

¹³ As already stated in case SK/2017/2010 by both BEREC (BoR (17) 251) and the Commission (C(2018) 1035), in case SI/2018/2050 by both BEREC (BoR(18) 55) and the Commission (C(2018) 930 final), and confirmed by BEREC in its opinion on the present case, the size premium is not commonly applied by NRAs in the EU. BEREC also recalled that the use of a size premium is not addressed in the 2017 BEREC report 'Regulatory Accounting in Practice'.

Insufficient empirical evidence supporting the use of a size premium

- (38) Beyond the above methodological arguments, the Commission finds that the justification for the size premium provided by RÚ is not well-grounded.
- (39) According to RÚ, the size premium should account for the fact that Slovak telecoms operators are smaller and have a lower credit rating than the European companies used as reference. In support of this line of argument RÚ cited two sets of studies¹⁴.
- (40) Contrary to that, the Commission emphasises that a number of recent studies dispute the evidence relied upon by RÚ to justify the use of a size premium and clearly call into question the existence of such a size effect in today's market context¹⁵. Most importantly, many contend that evidence of a size effect has not been observed since the early 1980s in the United States and is weak or non-existent in other countries¹⁶. The studies referred to above use several other arguments to question the need for size premia, including the fact that small firm effects have at most been observed only for very small stocks¹⁷ or that most or all of the small size effect is in fact a liquidity effect, i.e. it reflects the higher liquidity risk faced by small firms and tends to disappear once illiquidity is accounted for¹⁸.
- (41) The Commission considers that any non-diversifiable risk associated with the stocks of Slovak SMP operators should be reflected in its equity beta, including any risks associated with its smaller size. For this reason, it would have been more appropriate for RÚ to also reflect on the equity beta, the gearing and the cost of debt of the Slovak regulated firm, rather than relying solely on the use of a peer group, to estimate the values used in its WACC estimation. This said, in evaluating the SMP operator's beta, RÚ should also take into account that individual beta values may be inflated by the additional financial risk associated with relatively higher leverage. For this reason, while relying on the SMP operator's equity beta, the beta used should in principle be consistent with that of similar peer companies in other EU countries. A good practice would be to ensure that the adopted equity beta value be within a range of values of similar EU telecoms companies with: (i) investment grade¹⁹; (ii) most of their

¹⁴ These are i) the Ibbotson Associates Studies, and ii) the Standard&Poor's Corporate Value Consulting Studies. Both sets of studies use rate of return data developed at the University of Chicago Center for Research in Security Prices (CRSP) and are published under Duff & Phelps name.

¹⁵ The observation of a size effect in the present market situation is widely disputed. See e.g. A. Damodaran, *The Small Cap Premium: Where is the beef?*, cit., including the literature cited therein, and M. A. Crain, *A Literature Review of the Size Effect*, 29 October 2011, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1710076. The use of a size premium is also questioned in a recent report by the UK Regulators Network (UKRN), "Estimating the cost of capital for implementation of price controls by UK regulators", 6 March 2018, available at <http://www.ukrn.org.uk/news/estimating-the-cost-of-capital-for-implementation-of-price-controls-by-uk-regulators/>.

¹⁶ This is argued by all the sources cited in the footnote above. See also J. Hsu and V. Kalesnik, *Finding Smart Beta in the Factor Zoo*, July 2014, available at https://www.researchaffiliates.com/en-us/publications/articles/223_finding_smart_beta_in_the_factor_zoo.html.

¹⁷ See A. Damodaran, *The Small Cap Premium: Where is the beef?*, cit., and J. L. Horowitz, T. Loughran and N. E. Savin, "The disappearing size effect", *Research in Economics*, 2000, vol. 54, issue 1, 83-100, showing that any statistically significant size effect vanishes when removing the smallest firms from the sample (less than USD5m market value).

¹⁸ See A. Damodaran, *The Small Cap Premium: Where is the beef?*, cit., and M. A. Crain, cit., and the literature cited therein, as well as the UKRN report, cit.

¹⁹ Investment grade is a type of bond credit rating typically associated with bonds with the highest quality and minimal risk.

company revenues originating from the EU; and (iii) most of their revenues from similar activities as those being regulated.

Unjustified level of the size premium

- (42) Finally, even if one were to assume, for the sake of argument, that the use of a size premium could be justified, the Commission considers that RÚ fails to adequately explain its choice to set the level of the premium at [REDACTED] percentage points.
- (43) RÚ clarified that, based on the Duff & Phelps 2017 Valuation Handbook, it used size premium values recommended for companies with a market capitalisation between USD [REDACTED] and USD [REDACTED]m²⁰ (micro-cap decile [REDACTED]). According to RÚ, the majority of Slovak companies fall within that range, while telecoms operators other than Slovak Telekom are much smaller than the latter and are not listed on the stock exchange.
- (44) However, as stated by BEREC in its opinion, the Commission points out that RÚ did not justify why it would be appropriate to use Duff & Phelps data on US companies to derive the value of the size premium suitable for Slovak companies. As a matter of fact, RÚ did not present any evidence pointing to the existence and magnitude of size effects in Europe or specifically in Slovakia.

Conclusion

- (45) In light of all the above, the Commission stands by its position outlined in the serious doubts letter that the notified WACC is not likely to actually reflect the currently prevailing competitive conditions in both the relevant market and the capital markets in Slovakia, taking into account the risk incurred by the investing undertakings. In particular, RÚ failed to demonstrate that the notified WACC would represent a reasonable rate of return on adequate capital employed which would encourage efficient investments and would promote efficiency and sustainable competition and would maximise consumer benefits.
- (46) The Commission therefore concludes that the proposed calculation of the WACC does not comply with the policy objectives set in Article 8(2)(a) and 8(5)(d) of the Framework Directive and is not in line with Article 13(1) and (2) of the Access Directive.
- (47) On the basis of the above, and recalling its reasons expressed in the serious doubts letter, the Commission issues the present recommendation requiring RÚ to amend or withdraw the draft measures.

HEREBY RECOMMENDS:

1. RÚ should amend or withdraw the remedies relating to price caps for fixed call termination services in Slovakia in order to bring its WACC calculations in line with the policy objectives set out in Article 8(2)(a) and 8(5)(d) of the Framework Directive, and therefore comply with Article 13(1) and (2) of the Access Directive.
2. RÚ should avoid overestimating the cost of equity, in particular by ensuring that the “size premium” mark-up is not included in the WACC calculation.
3. The Commission will publish this recommendation on its website. RÚ is invited to inform the Commission within three working days following receipt of this recommendation whether it considers that, in accordance with European Union and

²⁰ Market capitalisation for the smallest and for the largest company respectively.

national rules on business confidentiality, it contains confidential information which RÚ wishes to have deleted prior to publication. Any such request should be reasoned.

4. In accordance with Article 7a(7) of the Framework Directive, where RÚ decides not to amend or withdraw the notified draft measure on the basis of this recommendation, it shall provide the Commission with a reasoned justification.
5. In accordance with Article 7a(6) of the Framework Directive, RÚ shall communicate the adopted draft measure to the Commission within one month of the Commission issuing this recommendation. This period might be extended, at RÚ's request, to allow RÚ to undertake a public consultation in accordance with Article 6 of the Framework Directive.
6. This Recommendation is addressed to RÚ.

Done at Brussels, 19.6.2018

*For the Commission
Mariya GABRIEL
Member of the Commission*