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COMMISSION RECOMMENDATION

of 17.12.2018

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 HU/2018/2107: wholesale high quality access provided at a fixed location in Hungary

{C(2018) 8650}

Only the Hungarian version is authentic

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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 observations pursuant to the provision cited above²,

Having regard to the opinion of the Body of European Regulators for Electronic Communication (BEREC)³,

Whereas:

1. PROCEDURE

1. On 16 August 2018, the Commission registered a notification from the Hungarian national regulatory authority, National Media and Infocommunications Authority (NMHH)⁴, concerning the market for wholesale high quality access provided at a fixed location⁵ in Hungary. The national consultation⁶ ran from 29 June 2018 for 20 days.

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/sd/a/1374460e-47d6-4618-9118-b75fa6b86e01/Notice%20to%203rd%20parties_HU_2107.pdf

³ Opinion of BEREC of 25 October 2018, BoR (18)205.

⁴ Under Article 7 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), 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.

⁵ Corresponding to market 4 in Commission Recommendation 2014/710/EU of 9 October 2014 on relevant product and service markets within the electronic communications sector susceptible to ex ante regulation in accordance with Directive 2002/21/EC of the European Parliament and of the Council on a common regulatory framework for electronic communications networks and services (Recommendation on Relevant Markets), OJ L 295, 11.10.2014, p. 79.

⁶ In accordance with Article 6 of the Framework Directive.

2. On 27 August 2018, a request for information⁷ was sent to NMHH and a response was received on 29 August. On 4 September 2018, a supplementary request for information was sent to NMHH and a reply was received on 5 September.
3. On 17 September 2018, the Commission, pursuant to Article 7 and 7a(1) of the Framework Directive, informed NMHH of the reasons as to why it believed that the draft measure would create a barrier to the internal market and why it had serious doubts as to the compatibility of the draft measure with EU law (the "Serious doubts letter").
4. On the same day BEREC was informed about the issuing of the serious doubts letter.
5. The Commission did not receive any third party observations.
6. On 10 October 2018 the Commission sent an additional request for information to NMHH and a response was received on 15 October.
7. On 25 October 2018, BEREC delivered its opinion on the Commission's serious doubts concerning the remedies imposed on the operator with significant market power (SMP), Magyar Telekom (MT). It partly supported the Commission's serious doubts.⁸
8. The Commission's serious doubts related to the designation of the SMP operator were subject to a separate BEREC opinion⁹. The Commission lifted its reservations indicated in its letter of serious doubts on 16 November 2018.¹⁰

2. DESCRIPTION OF THE ORIGINALLY NOTIFIED DRAFT MEASURE

9. The market for wholesale high quality access at a fixed location in Hungary was previously notified to and assessed by the Commission in 2011 under case number HU/2011/1269¹¹. At that time, NMHH proposed to split the market into two separate submarkets for analogue and TDM leased lines, according to bandwidth (up to 2 Mbit/s, and above 2 Mbit/s, respectively). Ethernet leased lines were excluded from the relevant market. With regard to higher bandwidth leased lines, NMHH considered that the structural barriers to entry were transitory, due to high potential returns as well as expected significant growth in that market. Even if the market share of alternative providers had not increased, NMHH considered that this market was evolving towards effective competition, hence proposed its deregulation. NMHH designated MT as having SMP in the market for low bandwidth leased lines, and imposed on it a full range of remedies¹², with the exception of price control.
10. In the draft measure currently under investigation, notified on 16 August 2018, NMHH significantly redefined the scope of the relevant market. The defined market, besides analogue and TDM leased lines, also included Ethernet leased lines¹³. The product market excluded the terminating segments of leased lines used to provide mobile backhaul. Moreover, the leased lines provided by operators MVM NET and NISZ to the government and to the owner of the electricity grid were excluded from the relevant market. Since 2012, the two operators are obliged by law to provide

⁷ In accordance with Article 5(2) of the Framework Directive.

⁸ In accordance with Article 7(5) of the Framework Directive.

⁹ Opinion of BEREC of 15 October 2018, BoR (18)199.

¹⁰ C(2018) 7711.

¹¹ C(2011) 9502.

¹² Access, transparency, non-discrimination and accounting separation.

¹³ Due to technological developments and the evidence that customers are replacing analogue and TDM leased lines with Ethernet leased lines.

leased lines services to the above-mentioned customers, which in turn can only purchase leased lines services from the two operators. Therefore, this exclusive right effectively grants MVM NET and NISZ a legal monopoly in this part of the market.

11. Further, unlike in its previous market review, NMHH considered that the relevant wholesale market should not be divided according to bandwidths. NMHH considered that the increasing use of higher bandwidth products, as well as the overlap between prices for leased lines in adjacent capacity classes justified the definition of a single market encompassing all capacities. This conclusion was further supported by evidence of ease of switching to higher capacities, and more generally by the migration from analogue or TDM lines to Ethernet leased lines.
12. NMHH proposed to designate MT as the SMP operator. NMHH highlighted structural changes on the market (in particular the merger between MT and one of its competitors, GTS), high and stable market shares exceeding ■■■■, as well as other factors (absolute and relative size, control over infrastructure not easy to duplicate, absence of countervailing buyer power, access to capital, economies of scale and scope, potential competition, entry and expansion barriers).
13. NMHH proposed to impose on MT the following remedies: access¹⁴; transparency; non-discrimination; price control and cost accounting; and accounting separation.
14. As regards the price control obligation, NMHH proposed to allow MT to recover only costs directly related to the provision of wholesale terminating segments of leased lines. During the Phase I investigation, it remained unclear to the Commission whether and to what extent MT would be allowed to recover a share of joint and common costs, including the costs of its passive infrastructure, through the regulated fees.

3. SERIOUS DOUBTS EXPRESSED BY THE COMMISSION WHEN INITIATING THE SECOND PHASE UNDER ARTICLE 7A OF THE FRAMEWORK DIRECTIVE

15. On 17 September 2018, the Commission expressed serious doubts as to the compatibility with EU law of NMHH's draft measure concerning the imposition of remedies on MT.
16. The Commission had serious doubts as to the compatibility with EU law of NMHH's draft measure, in particular with the requirements referred to in Article 8(2)(a) and 8(5)(d) of the Framework Directive, in conjunction with Articles 13(1) and (2) of the Access Directive¹⁵, for the following reasons:

3.1. Under-recovery of MT's joint and common costs

17. NMHH proposed to allow MT only the recovery of costs *directly* related to the provision of terminating segments of wholesale high quality access services. From the notification and subsequent replies to the Commission's requests for information, the Commission understood that MT would not be allowed to recover through the wholesale charges any share of the costs of passive infrastructure, nor the

¹⁴ Only with regard to Ethernet leased lines, as access to other interfaces (analogue and TDM) is no longer relevant in view of technological progress.

¹⁵ Directive 2002/19/EC of the European Parliament and of the Council of 7 March 2002 on access to, and interconnection of, electronic communications networks and associated facilities, OJ L 108, 24.04.2002, p. 7, as amended by Directive 2009/140/EC, OJ L 337, 18.12.2009, p. 37.

proportionate share of its wholesale operations (administrative costs, overheads, IT systems, etc.).

18. Article 8(2) of the Framework Directive requires national regulatory authorities to promote competition and consumer benefit. According to Article 13(1) of the Access Directive, when imposing cost orientation, national regulatory authorities shall take into account the investment made by the operator, and allow a reasonable rate of return on the capital employed. A cost recovery mechanism which allows for the recovery of only direct costs, and not costs which are shared with other services, may not allow a sufficient return on capital as required by Article 13(1) Access Directive.
19. Moreover, given the clear downward price trends in almost all bandwidth categories in a largely deregulated market, it seemed disproportionate to the Commission to introduce strict price regulation that would prevent the SMP operator to recover the indirect costs sustained in the provision of wholesale leased lines.
20. Finally, where the costs of replacing or replicating leased lines were above the costs recovered through regulated access prices, this would not promote efficient investments or promote sustainable (infrastructure) competition as required by Article 8(2) of the Framework Directive and Article 13(2) of the Access Directive.
21. Therefore, the Commission considered that the price control mechanism, as proposed for wholesale high quality services, led to the under-recovery of costs of those services, and was therefore not in accordance with Article 8(2) of the Framework Directive and Article 13(1) and (2) of the Access Directive.

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

22. The weighted average cost of capital (WACC) is a component of a cost-oriented price to be applied by SMP operators in the market. 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. 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.
23. In this respect, the Commission had serious doubts that the level of WACC, as applied by NMHH, would reflect the currently prevailing competitive conditions, taking into account the risk incurred by the investing undertakings. NMHH adjusted the WACC formula by adding a mark-up ('size premium') in order to account for the smaller size of (and higher risks faced by) Hungarian companies compared to that of the other Union operators considered when calculating the equity beta in the WACC formula.
24. Such a 'size premium' corresponded to a mark-up of 0.8 percentage points in the cost of equity used for the WACC calculation, and increased the nominal pre-tax WACC from 7.39% to 8%.
25. First, as in cases SK/2017/2010¹⁶, SK/2018/2051¹⁷ and SI/2018/2050¹⁸, the Commission reiterated its view that such a mark-up for size is not commonly applied

¹⁶ C(2018) 1035.

¹⁷ C(2018) 3722.

by other NRAs in the EU. In these three Phase II openings, BEREC shared the Commission's position, noting in particular that neither BEREC's annual 'Regulatory Accounting in Practice' reports nor the 2016 report produced by the Brattle Group for the Commission "discuss the inclusion of a size premium when calculating the WACC using the CAPM to derive the cost of equity"¹⁹.

26. Second, the Commission did not consider the justification for the size premium provided by NMHH to be 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 Hungarian companies. Any additional diversifiable (i.e. non-systemic) risk associated to investing in Hungarian companies could in theory be diversified away by investing in companies in other countries or in other industries.
27. Third, NMHH did not provide sufficient information why the exact mark-up of 0.8 percentage points was appropriate for the calculation of the WACC of the Hungarian regulated company.
28. In the light of the above, the Commission considered that the mark-up should not have been included in the WACC calculation, as it would lead to an overestimation of the cost of equity, of the final value of the WACC and, correspondingly, of the prices of the regulated products.
29. To conclude, the Commission had serious doubts that the WACC value applied by NMHH, being subject to an unjustified size premium, promoted efficient investment and innovation, whilst ensuring that competition in the market is preserved and that consumers have the maximum benefit in terms of choice, price, and quality. The Commission considered that such mark-up was not in 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.

4. SCOPE OF THE PRESENT COMMISSION RECOMMENDATION

30. The current Commission Recommendation only concerns the Commission's serious doubts regarding the WACC calculation. The Commission's serious doubts regarding the perceived under-recovery of MT's joint and common costs are addressed in a separate Commission Decision (C(2018) 8650).

5. OBSERVATIONS SUBMITTED BY THIRD PARTIES

31. The Commission did not receive any comments from third parties concerning the case.

6. OPINION OF BEREC

32. On 25 October 2018, BEREC issued an opinion²⁰ on the Commission's letter of serious doubts pursuant to Article 7a of the Framework Directive, related to the remedies imposed on the SMP operator.
33. BEREC considered that the Commission's serious doubts on the WACC calculation were justified.

¹⁸ C(2018) 3644.

¹⁹ BoR (17) 251 in case SK/2017/2010, BoR (18) 67 in case SK/2018/2051, BoR (18) 55 in case SI/2018/2050.

²⁰ BoR (18) 205.

34. BEREC pointed out that the Commission expressed serious doubts about the application of a size premium in three previous cases.²¹ In all the cases BEREC considered those doubts justified.
35. First, BEREC noted that the issue of the size premium is not discussed in the Brattle report.
36. Moreover, BEREC argued that the use of a size risk premium was not consistent with the application of the capital asset pricing model (CAPM), i.e. the approach used by NMHH to estimate the WACC's cost of equity.
37. While NMHH argued that MT is relatively small compared to its European telecoms peers, it did not explain why it would face higher non-diversifiable risks than those faced by larger companies.
38. As in the previous cases mentioned above, BEREC was of the opinion that the use of a size premium in WACC calculations is not commonly applied by NRAs in the EU and that NMHH did not sufficiently justify the inclusion of a size premium in the WACC calculation. Thereby, BEREC concluded that such a mark-up was not in 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 for the reasons explained above.
39. In conclusion, BEREC was of the opinion that the Commission's doubts about the application of a size premium are justified.

7. CLOSE CO-OPERATION BETWEEN NMHH, BEREC AND THE COMMISSION AND CONCLUSION OF THE PROCEDURE

40. NMHH, BEREC and the Commission held a tripartite video conference call on 12 November 2018, to discuss the Commission's serious doubts and BEREC's opinion. The objective of the call was also to understand whether NMHH was prepared to amend its proposed remedies in its final measure to address the Commission's serious doubts (supported by BEREC).

8. ASSESSMENT

41. NMHH explained it did not intend to update its WACC calculation in its final measure, while it has committed to do so only when the Commission guidance on the calculation of the WACC will become available.
42. While welcoming NMHH's commitment to review WACC shortly in the future, the Commission considers that NMHH did not provide any additional justification during the Phase II investigation phase as to how its 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.
43. Since NMHH 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 NMHH to amend or withdraw the notified draft measure or may take a decision to lift its reservations indicated in the letter of serious doubts.
44. The Commission considers that the reservations expressed in its serious doubts letter regarding NMHH's approach to calculate the WACC remain valid.

²¹ Case SI/2018/2050, SK/2017/2010 and case SK/2018/2051.

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

45. 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 CAPM²². In contrast, other parameters of the CAPM 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 Hungarian companies. In the Commission's view, any additional diversifiable risk associated with investing in telecoms companies in Hungary could in theory be "diversified away" by investing in companies in other countries or in other industries.
46. The Commission therefore considers that it is not justified to apply such a mark-up. In fact, the size premium is liable to result in an overestimation of the cost of equity, which in turn is likely to significantly impact the final WACC value and, ultimately, the prices of the relevant regulated products.

Insufficient empirical evidence supporting the use of a size premium

47. Beyond the above methodological arguments, the Commission finds that the justification for the size premium provided by NMHH is not well grounded.
48. The Commission emphasises that a number of recent studies clearly call into question the existence of a size premium in today's market²³. Most importantly, many studies contend that evidence of a size premium was not observed since the early 1980s in the United States and is weak or non-existent in other countries²⁴. These studies use several other arguments to question the use of size premia, including: i) the fact that small firm effects have at most been observed only for very small stocks²⁵ or ii) 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 for²⁶.
49. The Commission considers that any non-diversifiable risk associated with the stocks of the Hungarian SMP operator should be reflected in its equity beta, including any risks associated with its smaller size. A good practice would be to ensure that the adopted equity beta value be within a range of values of similar EU telecoms companies.

²² As already stated in cases SK/2017/2010, SI/2018/2050 and SK/2018/2051 by both BEREC and the Commission, the size premium is not commonly applied by NRAs in the EU.

²³ 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/>.

²⁴ 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.

²⁵ 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).

²⁶ 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.

Unjustified level of the size premium

50. Finally, even if one were to assume that the use of a size premium was justified, the Commission considers that NMHH failed to adequately explain its choice to set the level of the size premium at 0.8 percentage points.
51. NMHH clarified that it based the choice of the size premium on the recommended value (1.62 percentage points) of the Duff & Phelps 2017 Valuation Handbook (which assesses size premia for US companies) and then applied a correction to reflect the smaller market capitalisation of Magyar Telekom, concluding on the size premium of 0.8 percentage points.
52. The Commission points out that NMHH 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 Hungarian companies. NMHH did not present any evidence pointing to the existence and magnitude of size effects in Europe or specifically in Hungary.

9. CONCLUSION

53. 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 reflect the currently prevailing competitive conditions in both the relevant market and the capital markets in Hungary, taking into account the risk incurred by the investing undertakings. In particular, NMHH failed to demonstrate that the notified WACC would represent a reasonable rate of return on adequate capital employed which would encourage efficient investments, promote efficiency and sustainable competition and maximise consumer benefits.
54. Article 7a(5) of the Framework Directive entitles the Commission, after taking utmost account of the opinion of BEREC (if any), to either issue a recommendation requiring the NRA concerned to amend or withdraw the draft measure, or to take a decision to lift its reservations indicated in accordance with Article 7a(4) of the Framework Directive.
55. 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.
56. On the basis of the above, and recalling the reasons expressed in the serious doubts letter, the Commission issues the present recommendation requiring NMHH to amend or withdraw the draft measures.

HEREBY RECOMMENDS:

1. NMHH should amend or withdraw the remedies relating to price regulation of MT's leased lines in Hungary 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. NMHH 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. NMHH 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 national rules on business confidentiality, it contains confidential information which

NMHH 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 NMHH 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, NMHH shall communicate the adopted draft measure to the Commission within one month of the Commission issuing this recommendation. This period might be extended, at NMHH's request, to allow NMHH to undertake a public consultation in accordance with Article 6 of the Framework Directive.
6. This Recommendation is addressed to NMHH.

Done at Brussels, 17.12.2018

For the Commission
Mariya GABRIEL
Member of the Commission