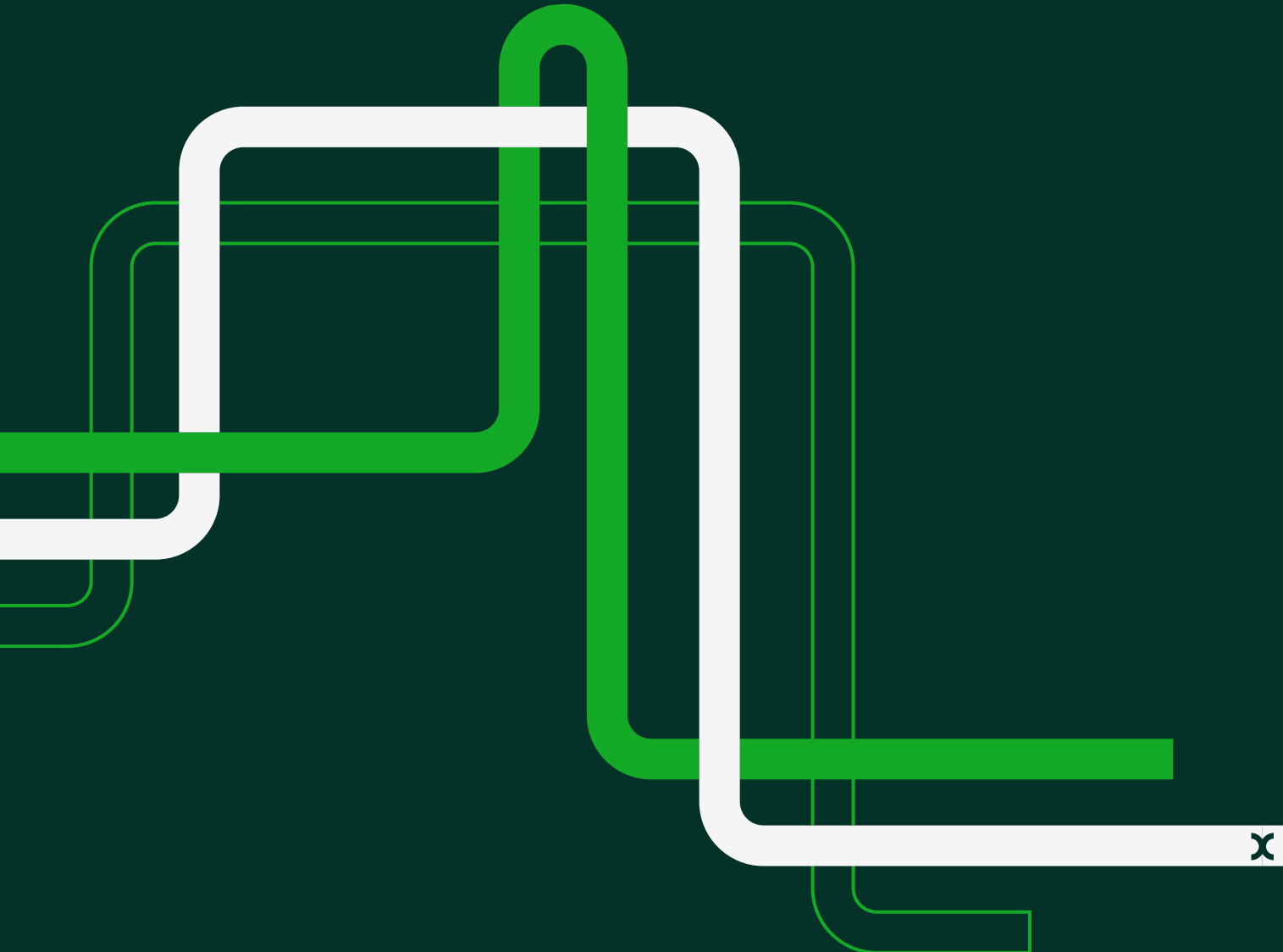


Oxera assessment of RATEL's proposed margin squeeze methodology

17 May 2024



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1 Introduction and summary

Oxera has been asked by Serbia Broadband d.o.o (SBB) to provide an economic assessment of the Serbian regulator, RATEL's, proposed approach to assessing the dominant broadband provider, Telekom Srbija's (TS), compliance with its regulatory obligation not to impose a margin squeeze in the Serbian market.¹

1.1 The importance of an ex ante margin squeeze test in Serbia

Since TS is a vertically-integrated firm with significant market power (SMP) in the provision of fixed broadband services at the wholesale level, there is a risk that it can use this market power to impose a margin squeeze on firms which purchase wholesale fixed broadband access to its network. It could do this by either (i) increasing wholesale access prices, and/or (ii) reducing retail fixed broadband prices to a level which would prevent an efficient operator, relying on access to TS' network, to economically replicate its retail offerings (that is, to earn a sufficient margin between retail and wholesale prices to recover its retail costs and earn a reasonable rate of return).

TS is subject to SMP remedies on the Wholesale Central Access at a fixed location for mass-market products (WCA) and Wholesale Local Access provided at a fixed location (WLA) markets, which require it, among other things, to offer wholesale access to its broadband network (for copper, Hybrid Fibre-Coaxial (HFC) and fibre-based access products) on a non-discriminatory basis and at cost-orientated prices². This mitigates the risk of a margin squeeze through the increasing of wholesale access prices, but not through the setting of retail prices.

1.2 European Commission guidance

The European Commission's Gigabit Recommendation provides advice on how National Regulatory Authorities (NRAs) in the EU should impose an ex ante margin squeeze, or economic replicability, test.³ In particular, it sets out eight parameters that the NRA should apply to an ex ante margin squeeze test (MST). These are as follows.

¹ RATEL (2024), 'Methodology of applying the market squeeze test to standalone and bundled service pricing'.

² RATEL (2023), SMP Designation Decision No 1-03-349-32/22-14 (4 May) 2023.

³ European Commission (2024), 'Commission recommendation of 6.2.2024 on the regulatory promotion of gigabit connectivity', para. 46–47 and Annex III, see <https://digital-strategy.ec.europa.eu/en/library/recommendation-regulatory-promotion-gigabit-connectivity>, (accessed 16 May 2024).

- 1 'The relevant downstream costs which are taken into account;
- 2 The relevant cost standard;
- 3 The relevant regulated wholesale inputs and reference prices;
- 4 The relevant retail products;
- 5 The relevant time period for running the test;
- 6 The methodology for determining the flagship products;
- 7 Whether flagship products are intended to be analysed on an individual basis or as a portfolio;
- 8 The approach that will be used for any unregulated products that are part of the flagship bundle.'⁴

The European Commission guidance goes on to provide further advice on the considerations that NRAs should make when applying these parameters.⁵ In our assessment of RATEL's proposals, we take account of this recommendation, alongside examples from other countries, and our view of the appropriate economics principles in the specific context of the Serbian telecoms market.

We note that RATEL refers to the European Commission's 2013 Recommendation⁶ in its methodology document. The 2013 Recommendation was replaced by the European Commission's Gigabit Recommendation in February 2024,⁷ so we consider the more recent publication to be the most relevant guidance. However, since the guidance in relation to ex ante MSTs is broadly the same in both recommendations, our assessment of RATEL's proposals would be materially the same regardless of the recommendation against which we considered it.

1.3 Summary of Oxera's assessment of RATEL's proposals

RATEL's proposed ex ante margin squeeze methodology seeks to address many of these eight parameters—for example, it considers the relevant upstream and downstream costs, the appropriate cost standard and the time period for running the test. However, we have identified instances where RATEL has either (i) not considered one of the parameters in the European Commission's guidance, (ii) its approach is

⁴ Ibid, para. 46(a).

⁵ Ibid, Annex III.

⁶ European Commission (2013), 'Commission recommendation of 11 September 2013 on consistent non-discrimination obligations and costing methodologies to promote competition and enhance the broadband investment environment', see <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32013H0466>, (accessed 16 May 2024).

⁷ European Commission, 'Commission welcomes new measures to boost the rollout of gigabit network', see https://ec.europa.eu/commission/presscorner/detail/en/IP_24_669, (accessed 14 May 2024).

not consistent with best practice, or (iii) not provided sufficient detail on the approach it would take to undertaking a part of its analysis.

We consider the following three issues to be of particular concern.

- 1 The treatment of revenues and costs over time.** RATEL is proposing to assess margins in its test using what it describes as a 'period-by-period' approach, where it calculates the margin on each product in each financial year, rather than the discounted cash flow (DCF) approach, which considers the flows of revenues and costs over the entire customer lifetime and estimates the net present value (NPV) of those cashflows at the weighted average cost of capital (WACC).

In practice, however, RATEL's approach can be more accurately described as a 'semi-dynamic' approach because rather than taking a 'snapshot' of the revenues and costs in a single financial year (as would be done in a typical period-by-period approach) it proposes to take account of upfront one-off items and initial discounts and promotions by spreading revenues and costs over the contract duration and costs over the customer lifetime, respectively to provide an average revenue and average cost. We have several concerns with RATEL's approach, which we discuss in section 2.3.1.

The DCF approach is considered the best practice approach as it can provide a more robust approach to assessing profitability. This is because it assesses both costs and revenues across the average customer lifetime (ACL), which is more appropriate where revenues and costs differ over time (for example if there are introductory discounts or one-off, upfront costs). This better reflects the economic situation faced by access seekers, for which profitability over the ACL (rather than in any given month or year) is relevant to decision making. It also accounts for the fact that the value of cashflows today are higher than those in the future (the 'time value of money') through discounting future cashflows. In contrast, RATEL's approach does not account for the time value of money, and is inconsistent in its treatment of costs and revenues over time (with a different time period used for each), which can distort the profitability assessment.

The European Commission Gigabit Recommendation advocates for profitability to be assessed on the basis of 'a dynamic multi-

period analysis, such as the discounted cash flow approach',⁸ and that the relevant time horizon should be set in accordance with the estimated ACL,⁹ in line with economic best practice.

- 2 **RATEL's approach to calculating a 'reasonable' profit.** RATEL proposes to apply an allowance for a return on capital on fixed assets in its margin squeeze calculation and, separately, a 'reasonable' profit. Our primary concern with RATEL's proposed approach is that it risks miscalculating the required 'reasonable profit'. This is the result of RATEL proposing to apply the WACC to the same cost items multiple times—once in the calculation of the own network and downstream costs and *again* as an uplift for reasonable profit, and as such potentially double counting the required returns. There are further conceptual issues with RATEL's proposed approach, which we discuss in section 2.3.2. From an economics and finance perspective, the DCF approach provides a more robust way to allow for a 'reasonable' rate of return through discounting future cashflows at the WACC.
- 3 **The exclusion of mobile services costs and revenues from the test.** RATEL proposes to exclude mobile service costs and revenues when testing bundles which include mobile products. Our view is that this approach is not appropriate as it risks enabling TS to more easily pass a MST when it provides heavy discounts on the mobile service element of a bundle, despite access-seekers not being able to economically replicate the bundle as a whole.

We have two main suggested changes to RATEL's proposals to remedy these concerns. These are for RATEL to:

- 1 use a DCF approach, rather than RATEL's semi-dynamic approach. This would (i) solve the concerns relating to the need to take account of the time value of money when revenues and costs are spread unevenly over time and, (ii) resolve the possible double-counting issue where RATEL is attempting to calculate a 'reasonable return'. Given that RATEL's semi-dynamic approach already spreads revenues and costs over time, a DCF approach does not represent a material increase in complexity. Indeed, in section 2.3 below, we explain how the

⁸ Ibid, Annex III, Recital (14).

⁹ Ibid, Annex III, Recital (15).

- DCF can be implemented in practice using the same data (on costs, revenues and the WACC) that RATEL would have needed to collect in any case to implement its proposed approach;
- 2 include all mobile costs and revenues in its assessments of bundles which include mobile services. This would ensure that all relevant cashflows are assessed in the MST and prevent TS from artificially passing a test if it includes heavy discounts on mobile elements in a bundle.

We have identified further areas where we are generally supportive of (our understanding of) RATEL's proposals or its apparent objectives, but in some cases require more information to properly assess how a margin squeeze assessment would apply in practice. In summary, these are the following.

- It is unclear from RATEL's proposals whether it intends to conduct the MST at a product-by-product level or at a more aggregated portfolio level (or some combination of the two)—we consider a product-by-product approach is appropriate in the context of the Serbian market and would ask RATEL to clarify that this is its proposed approach.
- We agree with RATEL's proposed choice of a LRIC+ cost standard.
- Whilst we agree with the principles underpinning RATEL's proposal to use a Reasonably Efficient Operator (REO) as its benchmark operator, we note that RATEL has not provided sufficient detail on how it intends to estimate the REO costs to make adjustment for economies of scale in situations where the costs and scale of operations of various access seekers in the market could differ significantly from each other. RATEL also does not provide details on the specific WACC rate it would use and what this would be based on. As a result, we foresee some practical difficulties in applying the REO standard as currently described by RATEL and we suggest that further detail is provided on how it intends to collect and use the cost information from access seekers.

The remainder of this document is structured as follow.

- In **section 2**, we present our concerns with RATEL's proposals in relation to its profitability approach.
- In **section 3**, we assess RATEL's proposals to exclude mobile service revenues and costs from its test.
- In **section 4**, we consider the appropriate products over which to carry out the MST.

- In **section 5**, we discuss why we agree with RATEL's proposals in relation to the relevant cost standard.
- In **section 6**, we present our view that RATEL's proposed approach to adjust for efficient access seekers with smaller economies of scale is appropriate in principle, but lacks the detail for us to understand how it would be undertaken in practice.

2 Profitability approach

2.1 Introduction

The profitability approach brings all the components of the margin squeeze test (MST) together by setting out the methodology to combine the costs and revenues to estimate the margin available to access seekers. In this section, we present:

- a summary of RATEL's proposed profitability approach and its justification for the proposed approach (section 2.2);
- our assessment of RATEL's proposed profitability approach, including its proposals in relation to the treatment of costs and revenues over time and allowance for a 'reasonable' profit (section 2.3).

2.2 RATEL's proposals

RATEL proposes to adopt a 'period-by-period' approach as the basis for assessing profitability.¹⁰ RATEL proposes to use financial years as the basis for the analysis, and rely on the observed revenues and costs recorded in the operator's accounts in that period.¹¹ RATEL explains that in its application of the period-by-period approach, the MST model will consider the 'customer lifetime of a product/service'.¹²

RATEL chooses the period-by-period approach over a discounted cash flow (DCF) approach and steady state approach because of its view that the period-by-period approach is 'based on actual data, simple to use and requires no estimations', in contrast to the DCF and steady state approaches which it views as 'highly complex' and being 'based on estimations of future inflows and outflows[...]'.¹³

RATEL's proposed profitability approach is captured by the formula below, which we have adapted from the MST methodology document:¹⁴

¹⁰ RATEL (2024), 'Methodology of applying the margin squeeze test to standalone and bundled service pricing', p. 6.

¹¹ Ibid, p. 6.

¹² Ibid, p. 6.

¹³ Ibid, p. 6.

¹⁴ To simplify the explanation of the objective of the MST, we have rearranged the formula to move 'reasonable profit' parameter from the left-hand-side to the right-hand-side. We have also replaced the variables in the original equation with descriptive terms to aid with this explanation. Source: RATEL (2024), 'Methodology of applying the margin squeeze test to standalone and bundled service pricing', p. 17.

$$\begin{aligned} & \text{average monthly revenue [excluding mobile]} \\ & - (\text{average monthly wholesale costs} + \text{own network costs} \\ & + \text{downstream costs [excluding mobile]}) \geq \text{reasonable profit} \end{aligned}$$

In essence, RATEL's proposed approach seeks to ensure that the available margin, given by the difference between (i) the average monthly revenues and (ii) the average monthly costs, provides (at least) a 'reasonable' level of profit. If this is the case, RATEL would conclude that the product is economically replicable to access seekers and the MST would be passed.

In its MST methodology document, RATEL provides further details on how it proposes to treat costs and revenues over time, and how it will determine a 'reasonable' level of profit. We discuss these specific proposals in more detail in the relevant sections below.

2.3 Oxera assessment of RATEL's proposals

Below, we set out our assessment of RATEL's proposed profitability approach. In particular, we provide our assessment of the:

- relevant time period and the treatment of costs and revenues over time (section 2.3.1);
- application of the weighted average cost of capital (WACC) and the approach to allowing for a 'reasonable' profit (section 2.3.2).

RATEL's proposed treatment of mobile services is linked to the proposed profitability approach. We deal with this issue separately in section 3.

2.3.1 The treatment of costs and revenues over time: a DCF approach should be adopted

RATEL's proposed methodology does not align with a typical 'period-by-period' approach

We first observe that while RATEL proposes to adopt what it describes as a 'period-by-period' approach, the proposed methodology does not align with this approach in terms of the treatment of costs and revenues.

As recognised by RATEL, a period-by-period approach would be based on actual data in each financial year, meaning that one-off costs and revenues would be considered only in the period in which they arose,

even though they can relate to multiple periods.¹⁵ However, RATEL goes on to explain that it will convert costs and revenues into average monthly costs and revenues by spreading one-off costs and revenues, and promotional discounts, over time. In the case of one-off costs, these are spread across the average customer lifetime (ACL); in the case of one-off revenues and promotional discounts, across the contract term.¹⁶ In spreading these costs and revenues over time, RATEL does not apply a discount rate to account for the 'time value of money'.

Therefore, in practice, we consider that the methodology proposed by RATEL can be more accurately described as a 'semi-dynamic' approach, rather than a period-by-period approach.¹⁷ This is because it distributes costs and revenues over time, but does not apply any discount rate.

Related to this issue, we note that RATEL's proposed approach distributes the costs and revenues over different periods of time. This will distort the profitability assessment.

A DCF approach would be consistent with economic best practice

Notwithstanding the issue of whether RATEL has proposed to implement a 'period-by-period' or 'semi-dynamic' approach, we consider that a DCF approach, performed over the ACL, is preferable, and more aligned with economic best practice.

The reason for this is that the DCF approach can provide a more robust means of testing the economic replicability of a product for access seekers on a forward-looking basis. The DCF approach allows the margin to be negative in any given sub-period within the ACL (for example, an individual month), as long as the overall margin across the ACL is positive once all the discounted cash flows are aggregated. The ACL corresponds to the relevant period of time over which an access seeker will generate revenues and incur costs in supplying services to a given customer and thus represents the relevant time period over which to assess the margin. Therefore, this approach more closely reflects the

¹⁵ RATEL (2024), 'Methodology of applying the margin squeeze test to standalone and bundled service pricing', p. 6.

¹⁶ Ibid, pp. 7, 11 and 15.

¹⁷ This description of RATEL's MST is based on our interpretation of RATEL's proposed approach to distributing cost and revenues over time (see section 3.4 of RateL's MST Methodology) and the description of how it would implement this in practice (see section 4 of RATEL's MST Methodology). If our description does not accurately reflect RATEL's proposals, it should clarify its proposals in respect of the relevant time period for the MST and the approach to distributing costs and revenues over time.

economic situation facing access seekers, rather than the artificial segmentation into 'periods'.

In particular, the DCF approach is more suitable where the future profile of cash flows (revenues and costs), and hence margins, vary over time (in particular across sub-periods within the ACL). For example, revenues may change over the ACL if there are introductory discounts available which reduce the monthly price paid by consumers for a period of time, or in circumstances where some revenues are generated only once in the first month of the ACL, such as fees for installation. Similarly, there may be one-off upfront costs incurred, such as the cost of customer premises equipment, and costs may change over time if, for example, unit costs are expected to rise in the future. Under a DCF approach, all costs and revenues are accounted for within the relevant month in which they occur during the ACL, and are multiplied by an appropriate discount rate (equal to the WACC). This reflects the 'time value of money' (the concept that consumers value costs incurred and revenues generated today more than equivalent costs and revenues in the future) and hence allows for a reasonable level of returns within the MST.

Consistent with economic best practice, the European Commission advocates for a DCF approach to be used to assess profitability over the ACL. Specifically, in the Gigabit Recommendation, the European Commission recommends that when conducting an ex ante MST, profitability should be assessed on the basis of a dynamic multi-period analysis, such as the discounted cash flow approach,¹⁸ and the relevant time horizon should be set in accordance with the estimated ACL.¹⁹

This DCF approach to assessing profitability has been adopted by European NRAs. For example, in its review of the WLA and WCA markets, ComReg has implemented a DCF approach to assessing profitability in the MSTs it applied to FTTH services.²⁰

What would a DCF approach look like in practice?

¹⁸ European Commission (2024), 'Commission Recommendation of 6.2.2024 on the regulatory promotion of gigabit connectivity', Annex III, Recital (14).

¹⁹ Ibid, Recital (15).

²⁰ ComReg (2024), 'Market Reviews; Wholesale Local Access (WLA) provided at a fixed location; Wholesale Central Access (WCA) provided at a fixed location of mass-market products; response to Consultation and Final Decision', 18 January, paras. 9.786–9.793, see <https://www.comreg.ie/publication/market-reviews-wholesale-local-access-wla-provided-at-a-fixed-location-wholesale-central-access-wca-provided-at-a-fixed-location-for-mass-market-products-non-confidential-response-to-consultatio>, (accessed 16 May 2024).

Under the DCF approach, the MST ensures that, in net present value (NPV) terms, the ongoing monthly margin generated over the ACL is sufficient to recover the (net) upfront costs. Where this is case, the product is considered to be economically replicable to access seekers and the MST is passed. More specifically, under the DCF approach:

- Upfront one-off costs and revenues should be included in full in the first period of the analysis (i.e. the first month of the ACL).
- The stream of revenues should include the expected recurring monthly revenues over the ACL, which will generally reflect the monthly retail price and any other relevant recurring revenues. The monthly revenues should reflect any promotional discounts on the monthly retail price in the month in which they occur during the ACL.²¹
- The stream of costs should include the expected recurring monthly costs associated with the provision of the product. This should include any one-off capital costs. These capital costs should be amortised across the relevant asset life to provide an annualised charge (including a return on capital) that should be included in the test as a recurring cost (see section 2.3.2 for more detail on how this is implemented in practice).
- The total margin should be estimated across the ACL in NPV terms, to reflect the time value of money. The discount factor used to calculate the NPV should be given by the WACC.

The DCF approach can be summarised by the following formula:

$$\begin{aligned} & (\text{upfront revenues} - \text{upfront costs}) \\ & + (\text{NPV of recurring revenues} - \text{NPV of recurring costs}) \geq 0 \end{aligned}$$

A DCF approach does not represent a material increase in complexity

In justifying favouring its proposed approach over the DCF, RATEL states that its proposed approach is simpler and requires no estimations, while the DCF is highly complex based on estimations of future inflows and outflows.²² However, we consider that implementing a DCF approach

²¹ For example, if there is a product on which a promotional monthly price is available for the first six months of the contract. Under the DCF approach, the promotional monthly price is reflected in the first six months of the ACL, before reverting back to the undiscounted price from the month seven.

²² RATEL (2024), 'Methodology of applying the margin squeeze test to standalone and bundled service pricing', p. 6.

would not represent a material increase in complexity relative to RATEL's proposed approach.

RATEL's approach already proposes to spread costs and revenues over time. As explained above, the two main differences under the DCF approach would be that (i) revenues and costs are accounted for in the MST as cash inflows and outflows in the relevant period in which they occur within the ACL, rather than being distributed to create a monthly average, and (ii) the future cash flows are discounted by the WACC (which provides an allowance for a reasonable rate of return). This approach could be implemented using the same data (on costs, revenues and the WACC) that RATEL already proposes to rely on under its proposed MST approach.

One factor that needs to be considered under a DCF approach is that the costs and revenues need to be considered on a forward-looking basis over the ACL. This requires consideration of how costs and revenues may evolve over the ACL. In terms of costs, one needs to consider whether the unit costs are expected to remain stable or change, for example as a result of inflationary pressure, over the ACL. In the case of revenues, this is generally more straightforward, as the prices charged are typically stipulated in the contractual agreement. However, where the contract term is shorter than the ACL, one must consider the stream revenues to include in the MST over the period of the ACL after the end of the initial contract term (as discussed in the next sub-section).

If it is known that costs and/or revenues will change over the course of the ACL and this can be clearly evidenced, this should be reflected in the MST. This is particularly important if costs are expected to rise and/or revenues are expected to fall, over the course of the ACL. If this is not accounted for, there is a risk that the MST is erroneously passed when it would otherwise fail if the 'correct' costs and revenues were used.

While this aspect of the DCF may introduce some additional complexity compared to RATEL's proposed approach, in particular in relation to costs, this should only be accounted for where there is clear evidence that the costs are expected to change in a predictable manner, thus limiting the degree of complexity. Where the environment is relatively stable and costs are not expected to change by a material amount, a simplifying assumption can be to use constant unit costs over the ACL.

RATEL's approach to amortising one-off costs and revenues includes implicit assumptions

A consideration within an MST that uses the ACL as the relevant time period is how to deal with products that have a contract term that is shorter than the ACL. This is because it may affect the profile of costs incurred and revenues generated over the ACL. To the extent that RATEL is proposing to conduct the test based on the ACL (which, as explained above, is not clear) there is a potential inconsistency in the time periods used to generate the average costs and revenues from the one-off costs and revenues, and the treatment of promotional offers.

Specifically, RATEL proposes to amortise one-off wholesale costs over the *ACL*; however, it proposes to amortise one-off revenues over the *contract term*. Similarly, if there is a product with a promotion available that provides a reduction on the monthly retail price for part of the contract term, RATEL proposes to spread this over time, calculating a weighted average monthly subscription price over the *contract term*.

To the extent that the ACL is longer than the contract term, we note that this approach implicitly assumes that the same average monthly revenues would continue to be generated in each month beyond the initial contract term for the remainder of the ACL—i.e. assuming that the consumer re-contracts on identical terms at the end of its contract term.²³ This may not accurately reflect the realities in the Serbia retail market and should be considered further by RATEL.

2.3.2 The application of the WACC and the approach to allowing for a 'reasonable' profit

There are conceptual errors with RATEL's proposed application of the WACC and calculation of 'reasonable' profits

To calculate the own network costs and downstream costs to include in its MST, RATEL appears to seek to include an allowance for a return on capital on fixed assets. Specifically, the formulae for calculating the own network costs (see section 4.2 of RATEL's methodology document) and downstream costs (see section 4.4 of RATEL's methodology document) includes the term: ' $NPV * WACC$ ', where: the '*NPV*' represents the net present value of a network element; and the '*WACC*' refers to the weighted average cost of capital.²⁴

²³ First, this approach assumes that the same monthly price (including any promotional discounts) would continue to be generated after the initial contract. Second, this approach assumes the same (monthly average share of) one-off upfront fees would be generated again, without including the corresponding costs (as the average one-off costs being distributed over the ACL).

²⁴ Ibid, pp. 13 and 15.

In determining the cost stack, RATEL also proposes to include an explicit allowance for a 'reasonable' level of profit (see section 4.7 of RATEL's methodology document). The level of 'reasonable' profit is given by the WACC multiplied by the sum of:

- the wholesale costs incurred by the access seeker;
- the costs of using network infrastructure (i.e. the access seeker's own network costs);
- the total downstream costs incurred by the access seeker.

There are four potential conceptual errors with RATEL's proposed approach to allowing for a return on capital and a 'reasonable' profit.

First, it is not clear why the calculation of downstream costs appears to include costs (including a return on capital) related to 'network elements'. The own network costs should only be captured *once* under the 'own network' costs, and not also under the 'downstream' costs. To the extent that own network costs are included twice, the cost stack in the MST and the 'reasonable' profit will be miscalculated. RATEL should ensure that there is no double counting of own network costs (including any return on capital) in the MST.

Second, it is not clear how the proposed allowance for a return on capital (specifically, the ' $NPV * WACC$ ' term in the calculation of own network costs and downstream network costs) would be implemented in practice and whether this would allow for an appropriate return on capital. Below, we explain how the DCF approach can allow for an appropriate return on capital on own network costs (and any other fixed assets in the MST). RATEL should provide a clearer explanation on this aspect of its proposed approach.

Third, RATEL appears to propose to apply the WACC to the own network costs and downstream costs *twice*: first, when calculating the amount of own network and downstream costs through the ' $NPV * WACC$ ' term; then *again* when calculating the amount of 'reasonable' profit, by multiplying the wholesale, own network and downstream costs by the WACC. This miscalculates the required level of returns. To the extent that the WACC is included as a basis for ensuring access seekers have the opportunity to generate sufficient returns, the (relevant) costs should be multiplied by the WACC only *once*.

Fourth, in calculating the level of 'reasonable' profit, RATEL proposes to apply the WACC to the wholesale costs incurred by the access seeker and the total downstream costs. Conceptually, this is incorrect as these

cost categories are not capital costs and so should not receive a return on capital, given by the WACC, in the manner proposed by RATEL.

How does the DCF approach allow for a reasonable level of profit?

The DCF approach ensures that access seekers are able to earn a reasonable rate of return by discounting future cash flows across the ACL by the WACC. From an economics and finance perspective, this is a more robust way to allow for a reasonable rate of return than RATEL's proposed approach. Moreover, if this approach was adopted, it would correct for the issues with RATEL's approach outlined above.

Under the DCF approach, careful consideration needs to be given to costs associated with fixed assets, such as the cost of network equipment and elements. These costs relate to assets which are not directly attributable to individual customers and which may have an asset life that differs from the ACL. These costs should be included in the DCF on an annualised basis; that is, they should include the depreciation costs (amortised over the asset life), plus a return on capital equal to the WACC. Box 2.1, below, provides an example of how these costs would be treated under the DCF approach.

This approach is consistent with the Gigabit Recommendation, which explains that under the DCF approach, downstream costs such as own network costs that are not included in the wholesale costs,²⁵ should be 'annualised according to a depreciation method that is appropriate to the asset in question and the economic lifetime of the corresponding assets required for the retail operations'.²⁶

²⁵ By downstream costs, this refers to all costs incurred by an access seeker, other than the wholesale input costs (i.e. this would capture the following cost categories referenced by RATEL: own network costs, other expenses necessary for service provision, and downstream costs).

²⁶ European Commission (2024), 'Commission Recommendation of 6.2.2024 on the regulatory promotion of gigabit connectivity', Annex III, Recital (15)(a).



Box 2.1 Treatment of fixed asset costs in the DCF

Suppose a network asset costs RSD 10,000 and has an asset life of five years. Therefore, the annual depreciation charge for this network asset would be RSD 2,000 (the capital cost of RSD 10,000 divided by the five-year asset life).

Suppose the annual WACC used in the MST is 10%.

If only the depreciation charge was included in the MST, this would not allow for a sufficient return on capital. This is because, when the depreciation charges are discounted by the WACC to give their NPV, the value is lower (RSD 7,582) than the initial capital outlay (RSD 10,000). Therefore, under the DCF approach the network asset costs should be included as an annualised cost including the depreciation charges *and* a return on capital (equal to the WACC). When this annualised cost is discounted by the WACC to give the NPV, the value is equal to the initial capital outlay. The table below summarises the depreciation charges and annualised figure (including a return on capital).

	Year 1	Year 2	Year 3	Year 4	Year 5	NPV
Depreciation cost	2,000	2,000	2,000	2,000	2,000	7,582
Annualised cost	2,638	2,638	2,638	2,638	2,638	10,000

Under the DCF the annualised cost would be converted to monthly costs and distributed across the total customer base reliant on that network asset to give a per customer unit cost.

Source: Oxera.

2.4 Summary

In general, RATEL's proposed profitability approach suffers from a general lack of clarity and appears to include a number of conceptual inconsistencies. In particular, we have highlighted concerns with RATEL's proposed:

- treatment of costs and revenues over time;
- application of the WACC and allowance for a 'reasonable level of profit'.

We consider that RATEL should measure the profitability using a DCF approach performed over the ACL, in line with economic best practice and the European Commission's Gigabit Recommendation. This approach can provide a more robust means of testing the economic replicability of a product for access seekers on a forward-looking basis. We consider that, if implemented correctly, this would help to ensure the following.

- 1 Costs and revenues which vary over time are treated appropriately, including accounting for the 'time value of money', and thereby avoid the potential inconsistencies with RATEL's approach in respect of the various time periods used.
- 2 The MST allows access seekers to earn a reasonable level of profit, by discounting future cash flows across the ACL by the WACC, in line with economics and finance best practice, and thereby avoid the miscalculation of the required level of profit implied by RATEL's approach.

3 The treatment of mobile services

3.1 Introduction

The treatment of bundles which include mobile services is a significant consideration for RATEL, since these products appear important to retail competition in Serbia. In Q4 2023, almost 20% of bundles purchased in Serbia included mobile services (the majority of which were quad-play bundles).²⁷ This information indicates a significant consumer demand for bundles which include mobile services.

In this section, we explain why a certain interpretation of RATEL's proposals to exclude the costs and revenues associated with mobile services could increase the chance of its MST failing to identify a margin squeeze where TS heavily discounts mobile services within a bundle.

3.2 RATEL's proposals

Where bundles offered by TS include a mobile element, RATEL is proposing to exclude both the revenues and costs associated with those mobile services from its MST.²⁸

It is clear which mobile **revenues** RATEL is proposing to exclude from the MST. This is the revenue generated from the mobile services segment of the bundle—RATEL suggests that typically TS states the mobile price separately from other elements of the bundle in a subscriber's bill, making clear what these revenues should be.

It is less clear how RATEL intends to exclude mobile-specific **costs** from the MST. RATEL notes that the appropriate approach would be to do so based on the outputs of a mobile BU LRIC model. However, RATEL is unable to use its existing mobile service BU LRIC model since it does not capture all the relevant mobile costs. Instead, it proposes to exclude mobile costs based on the 'standalone price of mobile network services'—an approach which assumes that this 'standalone price' is equivalent to the cost of providing the service.

There are two interpretations of RATEL's proposals for what the 'standalone price' would be based on.

²⁷ RATEL (2023), 'An Overview of the Electronic Communications Market in the Republic of Serbia: The Fourth Quarter of 2023', see https://www.ratel.rs/uploads/documents/empire_plugin/Q4%202023.pdf, (accessed 16 May 2024).

²⁸ RATEL (2024), 'Methodology of applying the market squeeze test to standalone and bundled service pricing', section 4.6.

- 1 It could be the price that TS sets for the specific mobile service within the bundle—i.e. the same price as it uses to calculate mobile revenues for that bundle.
- 2 It could be the price of other mobile services in the market which are purchased outside of the relevant bundle (for example, similar mobile services purchased on a standalone basis or within a different bundle).

Although it is unclear to us, one further interpretation of RATEL's proposals is that it intends to make a further adjustment in its MST for (downstream) costs which are common between mobile services within the bundle and the other bundle elements.²⁹ A possible interpretation of RATEL's approach is that it views the allocation of these costs between different bundle products to be 'proportional' and plans to exclude these costs from bundles which include mobile services, based on the downstream costs 'attributable to those services'. An alternative interpretation is that RATEL assumes that these costs are accounted for in the price of a 'standalone' mobile service, such that it does not need to make any further reductions to its assumed costs when excluding mobile services from the MST.

3.3 Oxera assessment of RATEL's proposals

Our view is that a best-practice MST should account for the costs and revenues of all services included within the bundles tested. By omitting certain costs and revenues—as RATEL proposes to do in relation to mobile services—the NRA risks mis-specifying the MST, leading to an inaccurate assessment of margins. We would, therefore, recommend that RATEL **includes all costs and revenues in its MST, including those relating to mobile services.**

Our specific concern with RATEL's current proposed approach is that, if it intends to estimate mobile costs by reference to prices of services not included within the bundle (i.e. our second interpretation above), there is a material risk that TS could be incentivised to offer bundles in which the mobile element is offered below cost, while the prices RATEL uses as its reference for mobile costs (for example, mobile services outside of bundles) are set significantly higher by TS. This could allow TS to pass the MST even where the costs of replicating the bundle exceed the revenues (on the basis that three out of the four components did pass the test).

²⁹ RATEL gives the examples of marketing, acquisition, billing and monitoring costs.

We illustrate this in the following simple example.



Box 3.1 Margin squeeze through mobile services example

In this simple example, we consider TS selling a hypothetical triple-play bundle which includes broadband, fixed telephony and mobile services for a price of 2,500 dinars. The costs that a reasonably efficient operator would bear to provide these services are:

- **Wholesale costs:** 1,000 dinars
- **Downstream costs:** 750 dinars
- **Mobile costs:** 1,000 dinars

Therefore, the total cost of providing the bundle is 2,750 dinars.

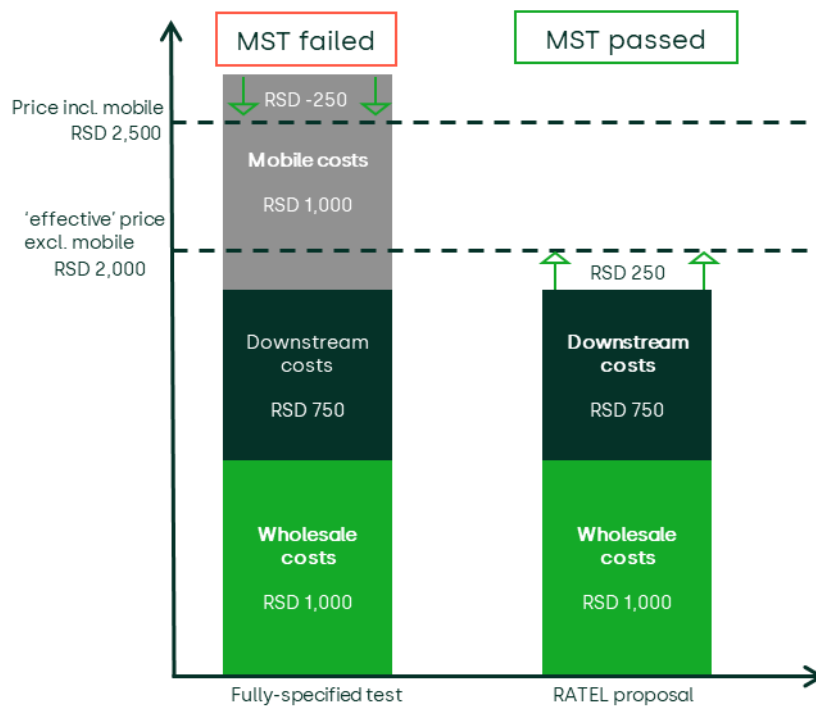
This bundle would fail a properly-specified MST since the costs of providing the service (2,750 dinars) are more than the revenues (2,500 dinars)—a negative margin of 250 dinars. This is illustrated by the bar on the left hand side of the figure below.

However, this is not the test that RATEL proposes to undertake. Instead, it would attempt to remove both the mobile revenues and costs from its model, before running its MST.

In this example, we assume that the (1,000 dinars) mobile cost RATEL has estimated is based on the price of a standalone mobile service that is available separate to the bundle it is testing (our second interpretation above). TS has heavily discounted the mobile element of the bundle so that it is priced at 500 dinars.

This results in TS removing 1,000 dinars from the cost stack of the MST, but only 500 dinars from the revenues, leading to an 'effective price' of 2,000 dinars compared to costs of 1,750 dinars. Once these costs and revenues are removed, the bundle (excluding mobile) appears to pass the test by 250 dinars—this is illustrated by the bar on the right hand side of the figure below.

In this example, therefore, RATEL's approach to excluding mobile service costs and revenues leads to a bundle passing the MST despite access seekers not being able to replicate the bundle as a whole.



Source: Oxera

This outcome would be detrimental to all access seekers (not just those that offer mobile services) if consumers who purchased fixed telecoms services from them and mobile services separately, reacted to the heavily-discounted bundle we presented in the example by consolidating their purchases with TS. This would not occur under a fully-specified MST, as all operators would be able to provide competitive bundles which either include mobile services or are attractive to consumers who choose to purchase their mobile services separately.

The issue described in our example would risk being further compounded if RATEL's proposals in relation to downstream costs are interpreted as it removing additional costs from the MST in proportion to a share of common costs it assumes are attributable to mobile. In our example, this would involve it removing the 1,000 dinars mobile cost stack plus a proportion of the 'downstream costs' stack, making it easier for TS to pass a MST on the hypothetical bundle.

3.4 Summary

We consider that RATEL should reconsider its proposals to exclude mobile service costs and revenues from its MST for the following reasons.

- 1 Bundles including mobile services are important to Serbian consumers and are, therefore, likely to be significant for competition.
- 2 There is a risk that TS could respond to these proposals by imposing a margin squeeze through setting mobile prices within bundles at a discount to standalone mobile prices. This may not be picked up under one interpretation of RATEL's proposals, as we have demonstrated in a simple example above.
- 3 This concern risks being compounded if RATEL proposes to include an additional cost reduction in its MST on the basis that there are further common costs attributable to mobile services which are not accounted for in its estimate of mobile-specific costs.

Such an approach would be consistent with the European Commission's Gigabit Recommendation which states that 'the economic replicability test can be applied either to: (i) individual products, which can be either bundled offers (which can include non-regulated products) [...]'.³⁰ It would also be consistent with approaches taken in other countries. For example:

- In the UK, Ofcom stated that it would account for the costs and revenues associated with any mobile services in its assessment of BT's VULA margin;³¹
- In Ireland, ComReg's methodology includes unregulated services, such as mobile telephony in its MST;³²
- In Belgium, the BIPT captures mobile revenues and costs if mobile products are sold in combination with services based on regulated wholesale inputs.³³

³⁰ European Commission (2024), 'Commission recommendation of 6.2.2024 on the regulatory promotion of gigabit connectivity', Recital (36).

³¹ Ofcom (2015), 'Fixed Access Market Reviews: Approach to the VULA margin', 19 March, para. 6.69–6.74, see

https://www.ofcom.org.uk/...data/assets/pdf_file/0015/72420/vula_margin_final_statement.pdf, (accessed 16 May 2024).

³² Commission for Communications Regulation (2023), 'Market Reviews: Wholesale Local Access (WLA) provided at a fixed location; Wholesale Central Access (WCA) provided at a fixed location for mass-market products', 9 January, para. 9.467–9.468.

³³ Belgian Institute for Postal Services and Telecommunications (2021), 'Communication du Conseil de l'IBPT du 22 Jun 2021 concernant les lignes directrices pour l'application de tests de compression de marge', 24 June, section 3.10, see https://www.bipt.be/file/cc73d96153bbd5448a56f19d925d05b1379c7f21/044c15bfc77570d15e0d49c3bbeff18446ce0708/ms_guidelines_2021_fr.pdf, (accessed 16 May 2024).

4 The scope of the test

4.1 Introduction

In this section, we consider how RATEL is proposing to apply its MST to the specific products in the Serbian market. In particular, we present our view that RATEL should apply the MST at a product-by-product level to restrict the flexibility that TS has to set lower prices on specific products which are particularly important to competition, while subsidising those lower prices elsewhere in its portfolio.

4.2 RATEL's proposals

The choice of the level of aggregation concerns whether the MST should be applied to products on a product-by-product basis, a portfolio basis (i.e. grouped across a number of products) or a combination of the two—a so-called 'combinatorial approach'. This assessment is captured under parameter (7) in the European Commission's Gigabit Recommendation—'whether flagship products are intended to be analysed on an individual basis or as a portfolio'.³⁴

RATEL's proposals do not explicitly consider the appropriate level of aggregation. The MST formula that RATEL presents in section 4.8 of its proposals is not clear on whether it is applied to individual products or across a wider portfolio. For example:³⁵

- RATEL states that the MST '[...] compares the dominant operator's subscriber revenue and the alternative operator's total costs incurred while providing the **same** bundle/service [emphasis added]'. This could indicate a product-by-product approach if it should be read as RATEL comparing the same products against each other in isolation.
- In the same section, RATEL states that 'if the resulting value is higher than zero, it means that there is no margin squeeze effect in the **market** [emphasis added]'. This could be interpreted as RATEL undertaking a market-wide assessment which would be equivalent to a portfolio approach.

³⁴ European Commission (2024), 'Commission recommendation of 6.2.2024 on the regulatory promotion of gigabit connectivity', para. 46.

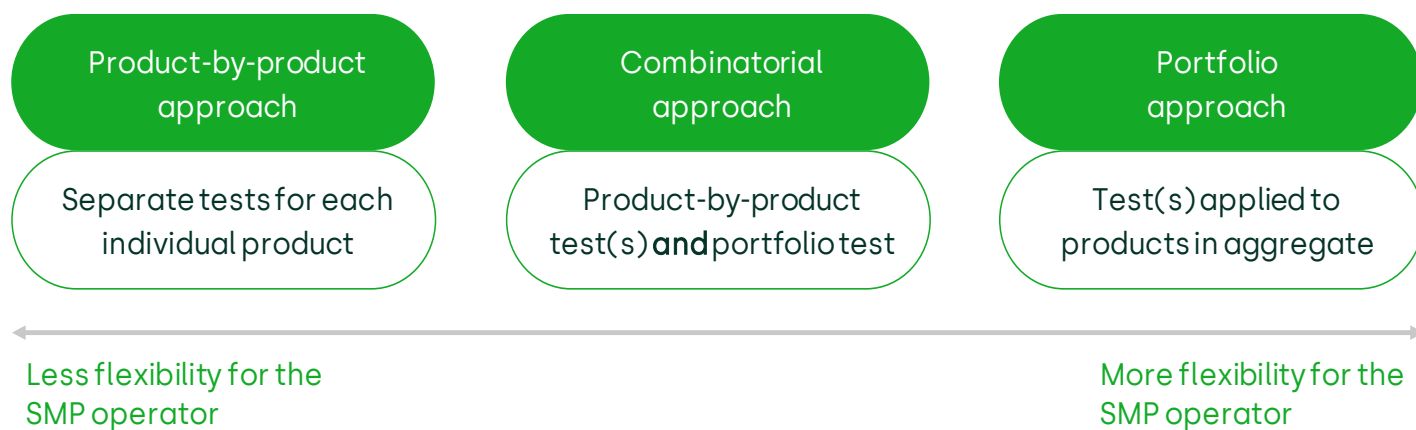
³⁵ RATEL (2024), 'Methodology of applying the market squeeze test to standalone and bundled service pricing', section 4.8.

Given this ambiguity, we cannot be certain which level of aggregation RATEL is intending to test.

4.3 Oxera assessment of RATEL's proposals

The appropriate level of aggregation at which to undertake the ex ante MST is context specific, and typically depends on the regulatory objectives of the NRA. This is because the choice of level of aggregation can determine the amount of flexibility afforded to the SMP operator to recover its common costs, as illustrated in Figure 4.1 below.

Figure 4.1 Product aggregation choice and the level of flexibility



Source: Oxera

Under a product-by-product approach, the SMP operator must recover a proportion of its common costs on each of its products, whereas it has more flexibility to cross-subsidise between products under the portfolio approach.

In this context, a product-by-product approach is likely to be relevant where the regulator considers it appropriate to ensure the economic replicability of specific products—in particular, products which access-seekers would rely on to remain competitive. This is to avoid the SMP operator setting lower prices for these products and cross-subsidising with higher prices on less important products (e.g. those which are based on legacy technologies).

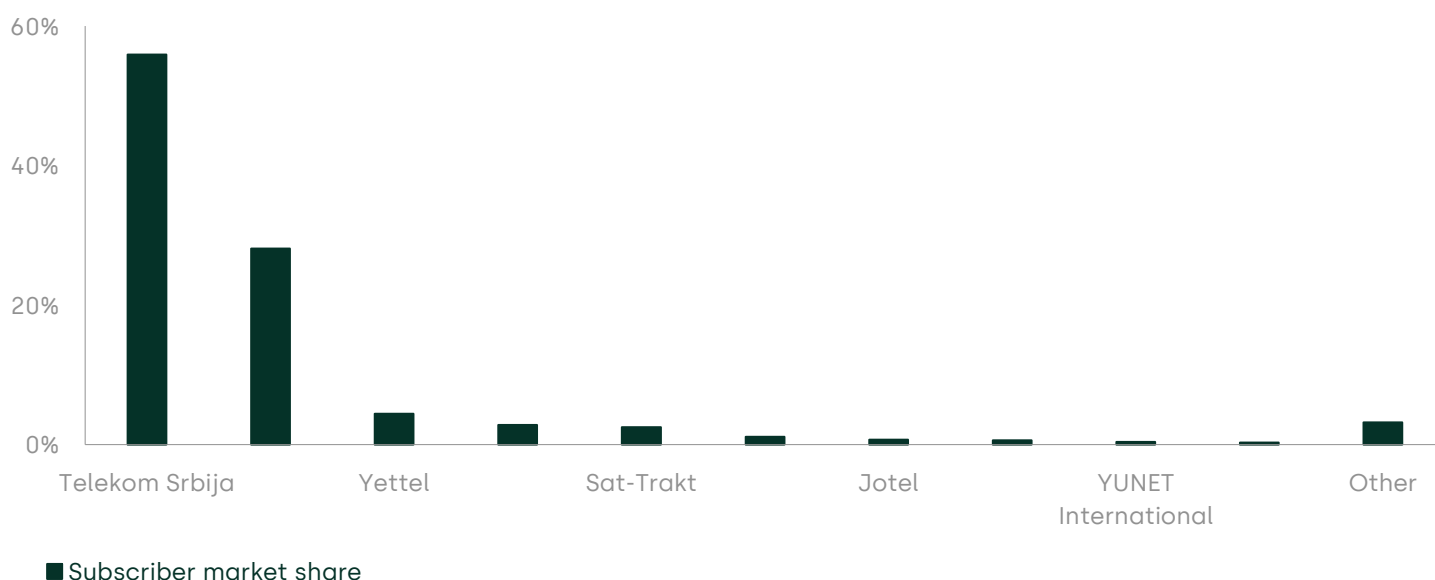
Alternatively, a portfolio approach would be more appropriate if access-seekers are more established, with a sustainable base of customers, offering a range of products. In this case, giving the SMP operator greater flexibility on how it sets prices across its products to

recover common costs is less likely to adversely affect competition in retail markets.

We are of the view that a product-by-product approach might be more appropriate than a portfolio approach in the Serbian context, since it would restrict the SMP operator from engaging in a margin squeeze on products which are particularly important to competition, while compensating with higher margins on less important products. In particular this is due to the following reasons.

- 1 There are a number of smaller retail telecoms operators in the Serbian market (as illustrated in Figure 4.2, below). These operators are likely to require protection across a range of different products to effectively compete at the retail level.

Figure 4.2 Serbian fixed broadband retail market share by subscriber (Q4 2023)



Source: Oxera; RATEL (2023), An Overview of the Electronic Communications Market in the Republic of Serbia, Q4.

- 2 There is substantial consumer demand in Serbia for a range of types of bundles. For example, in Q4 2023, there was significant demand for standalone services, as well as dual-, triple-, and

quad-play bundles.³⁶ This indicates that there is a range of products that smaller operators may need to offer so that they can compete with the SMP provider.

- 3 Uptake of fibre services is still relatively nascent (with only around 30% of consumers subscribing to FTTx services in Q4 2023³⁷). There is a risk that a portfolio approach would allow the SMP provider too much flexibility to undertake a margin squeeze to restrict competition on fibre-related services, while compensating with higher margins on older technologies.
- 4 RATEL's choice of benchmark operator (as we discuss in section 6) is predicated on an approach which facilitates market entry. This indicates a policy position by RATEL to protect competition from access-seekers, which is consistent with the objectives of using a product-by-product level of aggregation rather than a portfolio approach.

4.4 Summary

Based on this assessment of Serbian-specific factors, we would suggest that RATEL undertakes its MST on a **product-by-product** basis to ensure the economic replicability of the products Serbian access-seekers require to remain competitive.

³⁶ In Q4 2023, three types of bundles (Internet + fixed + television, Internet + television, Internet + fixed + television + mobile) were purchased by more than 16.5% of bundle consumers, while a significant number of total consumers purchased standalone Internet (15%), television (26%) and fixed telephony services (43%).

³⁷ RATEL (2023), 'An Overview of the Electronic Communications Market in the Republic of Serbia: The Fourth Quarter of 2023'.

5 The appropriate cost standard

5.1 Introduction

The choice of the appropriate cost standard is important because, similar to the level of aggregation we discuss in section 4, different choices of cost standard have different implications for the level of freedom TS has to recover its costs.

In the context of a product-by-product approach to the MST, we agree with RATEL that the appropriate cost standard is LRIC+ since it will ensure common costs are recovered (whereas alternatives such as LRIC would not).

5.2 RATEL's proposals

RATEL appears to propose to use the LRIC+ cost standard to estimate costs where the information is available, with the possibility of using fully allocated costs (FAC) where it is not. It proposes to use the SMP operator's reference offer pricing for regulated upstream costs and data provided by 'an alternative operator' for upstream network costs.³⁸

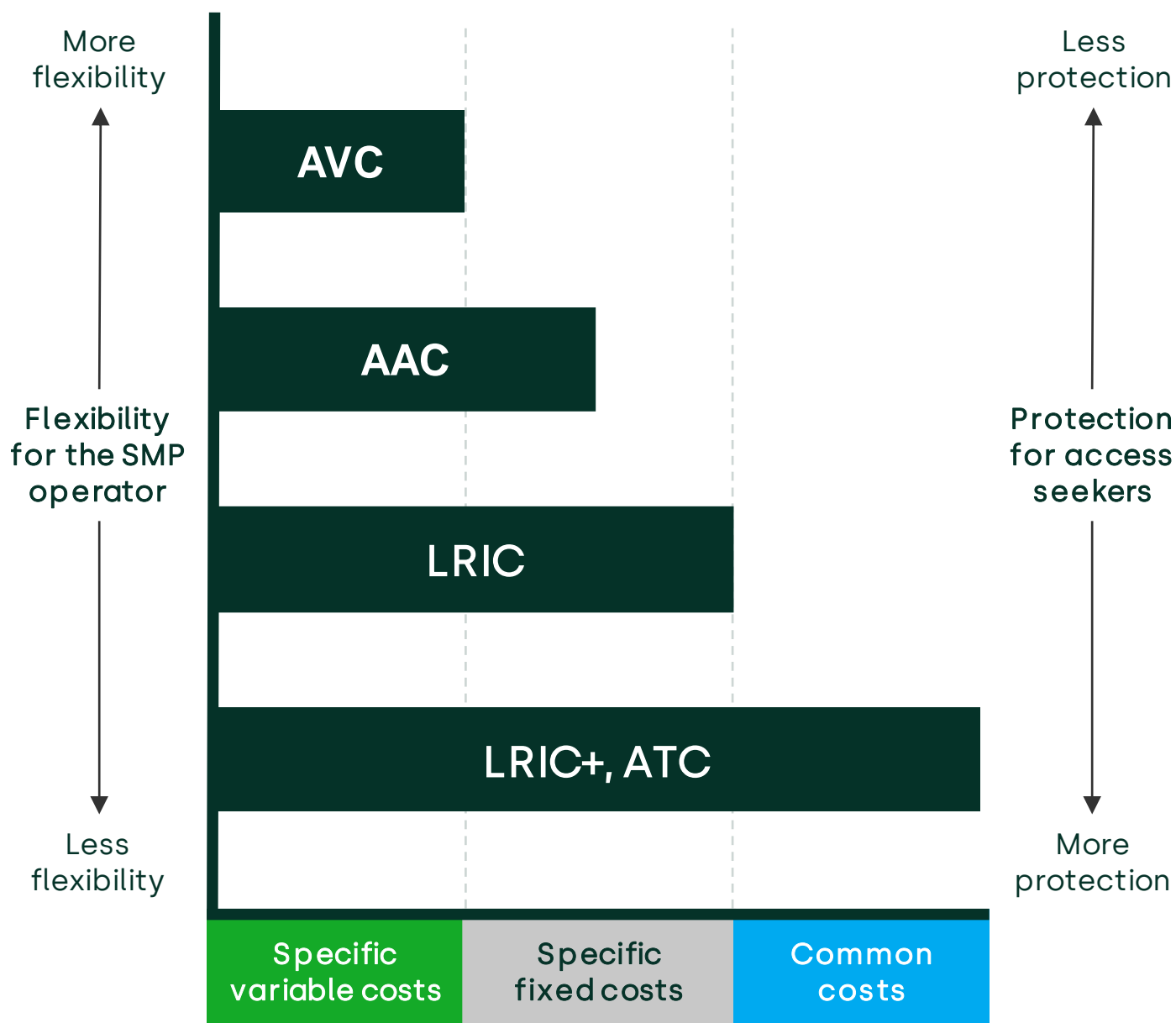
5.3 Oxera assessment of RATEL's proposals

The choice of cost standard is a crucial part of the MST as it determines the nature and size of the costs that are to be included in the test. There are a number of cost standards which could be applied, ranging from standards which do not include fixed costs (average variable costs) to those which include fixed costs and a proportion of common costs which are not directly attributable to any product or service (such as LRIC+ or average total costs).

The NRA's choice of cost standard should reflect a trade-off between the flexibility provided to the SMP provider (regarding the extent to which it accounts for common costs in its pricing decision) and the level of protection offered to its competitors—a cost standard which includes common costs will allow more protection to access seekers, as it forces the SMP operator to set higher prices (to account for common costs) allowing for larger margins. This is illustrated in Figure 5.1, below.

³⁸ RATEL (2024), 'Methodology of applying the market squeeze test to standalone and bundled service pricing', section 3.2.

Figure 5.1 Cost standard and the level of flexibility



Source: Oxera; European Commission (2009), 'Guidance on the Commission's enforcement priorities in applying Article 82 of the EC Treaty to abusive exclusionary conduct by dominant undertakings', 2009/C 45/02, 24 February.

Our view is that, given the reasons we have set out in section 4.3 (for example, the presence of a significant number of smaller retail providers), RATEL is correct to err on the side of providing more protection for access-seekers.

Importantly, the use of LRIC+ is consistent with the application of a product-by-product approach across all the SMP provider's products, since using an alternative cost standard (such as LRIC) at this level of aggregation would not allow access seekers to recover their common

costs. Failure to allow TS to recover its common costs by using an alternative cost standard would allow it to engage in a margin squeeze and foreclose access seekers, in the context of a product-by-product level of aggregation.

We, therefore, agree with RATEL's (apparent) proposed approach to use a **LRIC+ cost standard** where data is available.

5.4 Summary

Our view is that, given the particularities of the Serbian telecoms market—particularly the consumer demand for a range of different bundles and a variety of smaller access-seekers—the most appropriate approach would be to undertake the MST on a product-by-product basis on all TS products relying on regulated wholesale inputs, using a LRIC+ cost standard. Doing so should provide sufficient protection to access-seekers by removing the risk that TS could impose a margin squeeze on specific products which are integral to competition, while enabling it to fully recover its common costs.

The preference for a LRIC+ cost standard is consistent with the European Commission's Gigabit Recommendation, which states that 'a long run incremental cost plus (LRIC+) model should be used to calculate the incremental cost (including sunk costs) and to add a mark-up for common costs related to downstream activities.'³⁹ The LRIC+ standard is widely used internationally in ex ante MST methodologies, for example in Croatia⁴⁰ and the UK.⁴¹

³⁹ European Commission (2024), 'Commission recommendation of 6.2.2024 on the regulatory promotion of gigabit connectivity', Annex III, para 3.

⁴⁰ HAKOM (2019), 'Metodologija Testa Istisikivanja Marže', p. 29, see https://www.hakom.hr/UserDocsImages/2020/odluke_rjesenja_presude/Metodologija%20testa%20istisikivanja%20mar%C5%BEE_20200331.pdf, (accessed 16 May 2024).

⁴¹ Ofcom (2015), 'Fixed Access Market Reviews: Approach to the VULA margin', 19 March, para. 5.54.

6 The benchmark operator

6.1 Introduction

The choice of benchmark operator informs the level of efficiency RATEL assumes when calculating the downstream and own network costs of the access seeker. The rationale for using an alternative cost benchmark to the SMP operator is, where access seekers have relatively small economies of scale compared to the SMP operator, they may have higher costs. Where the NRA considers it necessary to protect these smaller access seekers, or provide entry incentives, it can benchmark the costs in its MST against an operator which has smaller economies of scale than the SMP operator.

In this section, we consider RATEL's proposals to use an REO benchmark. We agree with the principle of making such a scale adjustment in the context of the Serbian market, but require more information from RATEL to understand its exact proposals.

6.2 RATEL's proposals

As RATEL identifies, there are typically three different approaches to designate the benchmark operator for an ex ante MST. These are to assume the access seeker's efficiency is consistent with:

- 1 An **equally efficient operator** (EEO)—i.e. one that has the same assumed efficiency as the SMP operator;
- 2 An **adjusted equally efficient operator** (adjusted EEO, or similarly efficient operator (SEO))—calculated using the SMP operator's costs, adjusted for differences in economies of scope and scale; or
- 3 A **reasonably efficient operator** (REO)—calculated using the costs of a selected subscale access seeker.

The REO and adjusted EEO scale adjustments are typically applied where the NRA has an objective to promote market entry at the retail level (from firms which are less efficient than the SMP operator). RATEL proposes to use the costs of a REO for its MST,⁴² suggesting that it has an objective to promote market entry from efficient, smaller-scale, operators. This is consistent with the Serbian Law on Electronic Communications which states that RATEL's objectives should include

⁴² RATEL (2024), 'Methodology of applying the market squeeze test to standalone and bundled service pricing', section 3.1.

'promoting competition, efficiency and effectiveness in performing activities in the electronic communications sector'.⁴³

6.3 Oxera assessment of RATEL's proposals

The choice of benchmark operator is driven by the specific conditions of the market, and the policy objectives of the NRA. In particular, if access seekers have relatively lower economies of scale relative to the SMP operator and the NRA has an objective to promote/protect entry, it is more appropriate to apply a REO or adjusted EEO scale adjustment.

Given that the Serbian market is characterised by a number of smaller scale operators (as we present in Figure 4.2), and RATEL's proposals indicate that it is aiming to facilitate market entry, we consider that the use of either a REO or an adjusted EEO benchmark is a reasonable approach.

However, crucially, RATEL does not provide any information beyond stating that it will use a REO benchmark operator. In particular, since the REO approach is predicated on using cost data from an alternative provider to the SMP operator, we would expect RATEL to provide information on where the alternative data would be sourced.

This is particularly important in the Serbian market, where the second operator, SBB, has a reasonably large scale (with 28% retail market share by subscriber in Q4 2023⁴⁴), while the smaller operators have a much smaller scale, each with less than 5% of subscribers in the retail market. If RATEL's objective is to protect the smaller competitors in the market, and incentivise entry from similar-sized firms, then it may choose to use these providers' costs as its REO costs.

An alternative approach to achieve similar regulatory objectives would be for RATEL to use an adjusted EEO scale adjustment. This approach would use TS' costs as a starting point, which would then be adjusted to reflect the appropriate scale of a new entrant. The European Commission's Gigabit Recommendation advises that, in assessing the scale adjustment to apply to the SMP operator's costs, the NRA should consider the following four factors.

- 1 The size of the largest competitors relative to that of the SMP operator.

⁴³ RATEL (2014), 'Law on Electronic Communications', Article 3(6).

⁴⁴ RATEL (2023), 'An Overview of the Electronic Communications Market in the Republic of Serbia: The Fourth Quarter of 2023'.

- 2 The number of competitors that are likely to be sustainable at each level of the value chain.
- 3 The current HHI at each level of the value chain and its expected evolution over time.
- 4 The size of the VHCN market in the Member State (which might influence the number of competitors that can be economically sustainable).⁴⁵

European precedent indicates that this scale should assume a 15–20% market share. For example, a 15% market share is used in the adjusted EEO (or SEO) tests in Belgium,⁴⁶ Croatia⁴⁷ and Norway.⁴⁸

The adjusted EEO approach may be preferable to the REO method since RATEL would not need to rely on cost information from a second operator and it would give it more flexibility to consider what it believes to be the appropriate minimum efficient scale in the market (rather than relying on information from existing operators, some of which have significant differences in their market shares).

Irrespective of whether an adjusted EEO or REO approach is adopted for the purposes of determining the level of costs, a further consideration is what WACC rate should be used in the MST. Under an EEO approach, the incumbent SMP operator's WACC is typically used as the measure of the required rate of return. However, with an adjusted EEO or REO approach, there could be a basis for diverging from this if there is a material difference in the WACC of other access seekers. RATEL should clarify what WACC rate it proposes to use in the MST and what this is based on, for example if it is another access seeker's WACC, and ensure its rationale is consistent with the benchmark operator assumption.

6.4 Summary

We agree in principle with RATEL's proposals to use a benchmark operator which facilitates and protects market entrants, since this appears to be consistent with its regulatory objectives and the context of the Serbian market (which has relatively few scale retail

⁴⁵ European Commission (2024), 'Commission recommendation of 6.2.2024 on the regulatory promotion of gigabit connectivity', Annex III, para 2.

⁴⁶ Belgian Institute for Postal Services and Telecommunications (2021), 'Communication du Conseil de l'IBPT du 22 Jun 2021 concernant les lignes directrices pour l'application de tests de compression de marge', 24 June, section 3.5.

⁴⁷ HAKOM (2019), 'Metodologija Testa Istisikivanja Marže', p. 18.

⁴⁸ Nkom (2021), 'Principles for use of margin squeeze tests for local access to Telenor's fibre access network in Market 3a (VULA fibre)', section 3.1.1, see https://nkom.no/english/market-regulation#market_3a_and_3b_local_and_central_access_at_a_fixed_location, (accessed 16 May 2024).

competitors). We are unable to provide an assessment of the detail of RATEL's proposed REO approach since it has not indicated which alternative operator would be the source of its cost data. We suggest that RATEL provides more detail on how it intends to practically estimate the costs of a REO, since this is critical for an assessment of its approach.

We note that a reasonable alternative to achieve the same regulatory objective, which would not require RATEL to request additional data, would be for it to use an adjusted EEO scale adjustment instead, assuming a 15–20% market share (consistent with European precedent).



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