Oxera

Does the universal service obligation represent an unfair burden for eircom?

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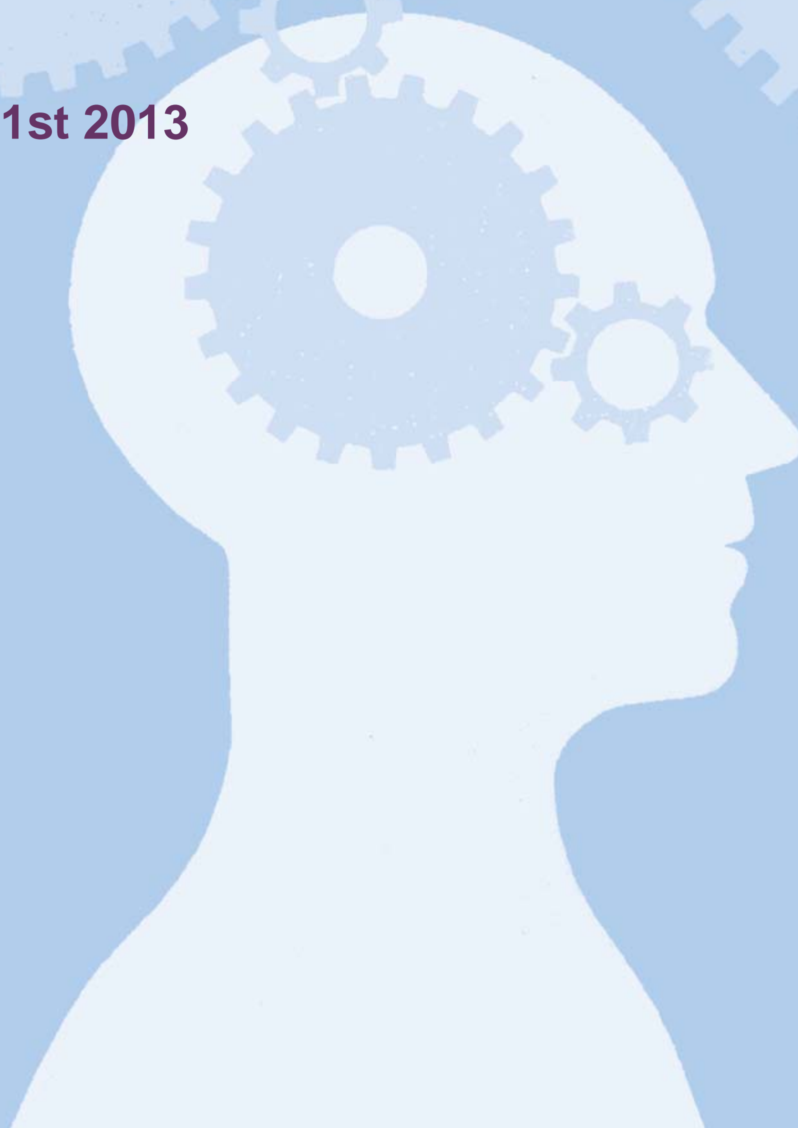

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1 Introduction

In its Report and Decision D04/11, the Commission for Communications Regulation (ComReg) established the principles and methodologies for assessing whether the universal service obligation (USO) represents a net cost that places an unfair burden on the universal service provider (USP).[1] In accordance with Irish legislation,[2] Decision D04/11 requires that, in order for the USP to receive compensation for any net cost, it is necessary to determine that there is an unfair burden.

The USO is likely to place a net cost on the USP that it would not otherwise have chosen to incur. Even so, a positive net cost, taking account of any intangible benefits, does not automatically imply that the USO represents an unfair burden or that USO financing is required. Indeed, while Decision 04/11 contains criteria that may indicate that the net cost imposes an unfair burden on the USP, ComReg notes that it will determine this on a case-by-case basis.

Such a case has now arisen, with eircom, the designated USP for Ireland, submitting an application for €6.2m of compensation for the net cost of the USO in 2009/10.[3] ComReg has commissioned Oxera to develop a conceptual framework, in accordance with D04/11, to help ComReg determine whether the USO represents an unfair burden for eircom. This includes providing practical advice on the implementation of the guidance in D04/11, and suggestions on how to consider the various assessment criteria together. Oxera has also incorporated relevant European Commission guidance, and regulatory precedents from other jurisdictions.

This report is structured as follows:

– section 2 considers ComReg's guidance on the determination of an unfair burden;
– section 3 addresses how this guidance could be applied;
– section 4 outlines how the determination of an unfair burden is approached in various international jurisdictions;
– section 5 concludes.

[1] ComReg (2011), 'Decision on the Costing of universal service obligations: Principles and Methodologies', 11/42, May 31st.
[2] As described in greater detail in section 2 below, and available at: http://www.irishstatutebook.ie/2003/en/si/0308.html.
[3] ComReg (2012), 'Universal Service Obligation: Application for funding from the Universal Service Provider for the period 2009/2010', 12/57, June 1st.

2 ComReg's guidance on the determination of an unfair burden

2.1 Overview of legal framework

In accordance with the Universal Service Directive 2002/22/EC (the 'Directive'), even if there is a verifiable direct net cost for the USP, it is necessary to establish whether that cost represents an unfair burden on the USP as a condition for whether USO financing should be considered. The Directive provides that there are two possible means of funding an unfair burden, and it is at the discretion of each Member State to determine which of these is implemented nationally, and what constitutes an unfair burden.

This requirement has been transposed into Irish legislation by Regulation 12 of the European Communities (Electronic Communications Networks and Services) (Universal Service and Users' Rights) Regulations 2011 (the 'Regulations').[4] This requires that, where found, an unfair burden is addressed by establishing a sharing mechanism, with other operators contributing to the cost of the universal service.

D04/11 establishes decisions and guidance for ComReg to consider before determining whether any net cost represents an unfair burden, and, as a direct consequence, in accordance with the Regulations, whether a sharing mechanism should be implemented.

In D04/11, ComReg sets out three cumulative conditions that must be met in order for the USO to represent an unfair burden:[5]

– there must be a verifiable direct net cost for the USP;
– the benefits accrued must not outweigh the net cost—ie, there must be a positive net cost;
– the positive net cost must be material compared with the administrative costs associated with a sharing mechanism, and must cause a significant competitive disadvantage for the USP.

ComReg also notes that it will consider, on a case-by-case basis, the financial and competitive circumstances faced by the USP and its competitors, relevant EU approaches, economic theory, and regulatory practices, to determine whether there is a positive net cost associated with providing the USO.

The legislative framework is set out in Figure 2.1.

[4] The Regulations are publicly available at http://www.irishstatutebook.ie/2003/en/si/0308.html.
[5] ComReg (2011), 'Decision on the Costing of universal service obligations: Principles and Methodologies', 11/42, May 31st.

Figure 2.1 Legislative framework for assessing an unfair burden and how it should be financed

Source: Oxera.

While the legal framework is clear, the definition of an unfair burden is not—neither the Directive nor the Regulations define the term 'unfair burden'. ComReg's guidance in D04/11 therefore needs to be applied in line with the intention and principles of the legislation more generally, rather than in the context of a specific legal test that defines the necessary or sufficient conditions for the presence of an unfair burden.

2.2 ComReg's three tests for determining an unfair burden

As noted above, ComReg, in D04/11, sets out the following three specific tests to be undertaken to determine whether a positive net cost of the USO represents an unfair burden.

2.2.1 Administrative cost assessment

If the positive net cost of the USO is relatively small, ComReg will assess whether USO financing is justified depending on whether the cost of establishing a sharing mechanism would be disproportionate to the net transfers to the USP. This assessment would take account of the regulatory best-practice principles of proportionality and practicality.[6]

2.2.2 Assessment of the USP's financial position

If the positive net cost is not relatively small, ComReg will assess whether it materially undermines a USP's profitability and/or ability to earn a fair rate of return on its capital employed.

ComReg indicates that this can be determined by looking at factors such as:[7]

- profitability, and changes in profitability, including an understanding of where the USP generates most of its profits over time;
- changes in accounting profits and related financial measures, such as earnings before interest, tax, depreciation and amortisation (EBITDA);
- changes in the direct USO net cost over time;
- estimates of the average level of cross-subsidy between classes of services that are more or less separately accounted for, and changes in these over time.

[6] ComReg (2011), 'Decision on the Costing of universal service obligations: Principles and Methodologies', 11/42, May 31st.
[7] ComReg (2010), 'Costing of universal service obligations: Principles and Methodologies', 10/94, November 30th.

ComReg notes that certain factors are not relevant to the assessment of the USP's financial position, such as its level of indebtedness, which is not driven by the USO.

2.2.3 Competitive distortions assessment

ComReg's final test assesses whether the net cost has a material impact on the USP's ability to compete on equal terms with competitors. Even if the USP can currently fund the USO—for example, because it can be cross-subsidised internally—the ability to do so may decline as competition intensifies in economic areas and the USP loses more profitable customers.

ComReg's decisions in D04/11 indicate that the extent to which the USO creates a competitive disadvantage for the USP could be determined by looking at three factors in particular:

– **market share**: the degree of competition faced by a USP in access markets, and how this market share has changed over time (including in related markets);
– **price uniformity**: whether competition in the most profitable segments of the market undermines the USP's ability to cross-subsidise USO customers;
– **price interaction**: the interaction with the retail price control in terms of the level of the price cap.

Other potentially relevant factors may include changes in prices over time, and market entry barriers.

2.3 Overview of legal framework

The three tests outlined above provide clarification beyond the Directive and the Regulations as to how ComReg will determine whether any net cost application represents an unfair burden on the USP. However, as with any such tests, they are not intended to be sufficient to create an unambiguous outcome for all potential applications.

Specifically, while each test can be assessed objectively, there may not be a single clear outcome from applying them all in practice, and it will be important to assess their outcomes on a case-by-case basis. For example:

– there is not a consistent approach to the definition of materiality in relevant precedent, and the concept of materiality would need to be considered in the context of both administrative costs and the impact on the USP's profitability;

– it may be difficult to assess whether the presence of a net cost has undermined the USP's profitability, because other factors may be present that could also undermine its profitability, such as changing demand conditions and/or efficiency;

– the impact of competition is difficult to measure and requires assumptions about the effect of the USO (by comparison to other factors) on the USP's ability to compete on equal terms with other operators.

In addition, both under the current application from eircom and in the context of future applications, assessments against each of the tests may not point towards the same outcome in terms of whether the net cost is an unfair burden. For example, the net cost of the USO may undermine the profitability of the USP but not affect its ability to compete in the market.

As explained in the next section, it may be necessary to analyse the outcomes of all the tests in combination, rather than taking each test in isolation, to be able to reach a view on whether the net cost represents an unfair burden, particularly where some or all of the tests

do not result in a clear-cut outcome.[8] Oxera's framework seeks to provide further clarity on how to establish whether each of the tests can be shown to be met, and how to approach a scenario where the overall conclusion, taking the tests in the round, is unclear.

The next section looks at how these tests can be applied in practice, and how ComReg could assess the presence of an unfair burden by taking all of the tests into account.

[8] For example, for a materiality test comparable to that within ComReg's Decisions 39–40, there is a range of outcomes for the impact on the USP's profitability that could be clearly stated as material, and a range of outcomes that are clearly not material. In between lies a third range that could be considered material depending on the chosen measure of materiality, and for which the outcome might indicate that this test can be considered only in the round alongside the other tests, rather than in isolation.

3 Applying ComReg's guidance

This section examines how the guidance, set out in section 2 above, could be implemented in practice. This includes consideration of how the tests might be performed in the context of eircom's current application, and data that would provide support in reaching a decision. It includes wider consideration of how ComReg could perform the case-by-case analysis discussed in section 2 for future applications.

For the purposes of this analysis, Oxera assumes that it has been determined that there is a positive net cost of the USO (ie, after incorporating any intangible benefits.) The analysis focuses on how ComReg could assess whether that net cost represents an unfair burden, by testing that cost against each of its three tests outlined in section 2.2.

3.1 Applying ComReg's decisions in practice

Oxera considers below an economic framework for determining whether, in the context of ComReg's decisions and guidelines and the legislative framework outlined in section 2, a positive net cost reflects an unfair burden.

The economic framework follows ComReg's Decisions 38–42 in D04/11. However, it is important to note that these decisions need to be taken together in a logical approach to the assessment of an unfair burden, and that the tests are cumulative in nature. In order to establish whether there is an unfair burden, Oxera proposes that the tests be applied to the decisions in D04/11 as follows, and specifically in this order, so that the information in Decision 42 can be used to reach a conclusion in respect of the tests in Decisions 40 and 41.

– **Is there a net cost (Decision 38, subsections 1 and 2)?** This section assumes that there is, and tests for the presence of subsection 3—ie, whether the net cost is material to administrative costs and causes a significant competitive disadvantage for the USP.

– **Is the net cost material to administrative costs (Decision 39)?** The analysis indicates that, at present, the materiality test in Decision 40 below is more important, and Decision 39 will be passed if Decision 40 is passed (see section 3.2.below).

– **What are the market and financial conditions faced by eircom (Decision 42)?** In reaching a view on Decisions 40 and 41, ComReg must take into account eircom's financial position and developments in the competitive market. Practical examples for how this might be assessed are included throughout this section.

– **Does the net cost significantly affect the USP's profitability (Decision 40)?** ComReg must use the data gathered in the context of Decision 42 to assess whether the net cost is affecting the USP's profitability, and whether any such effect is significant (see section 3.3).

– **Will the net cost have a material impact on the USP's ability to compete on equal terms with other operators (Decision 41)?** If there is a significant effect on the USP's profitability, ComReg would use the data on conditions within the competitive market to assess whether this is as a result of the net cost having a material impact on the USP's ability to compete (see section 3.4).

If the conclusion of this process is that the tests are met—in particular, the tests in Decisions 40 and 41 (as discussed further below)—this indicates that ComReg should find an unfair burden. However, the sections below also indicate the potential for a 'grey area' for some of

the analysis, and section 3.5 outlines how ComReg may come to a conclusion in that context.

3.2 Administrative cost assessment

If the positive net cost of the USO is relatively small, ComReg will decide whether financing is potentially justified by comparing the administrative costs of operating a sharing mechanism with the positive net cost of the USO, and, in particular, the net transfers to the USP. Decision 38 of ComReg's Decision states that:

> For there to be an unfair burden [the] positive net cost [must be] material compared to the administrative costs of a sharing mechanism

This section provides guidance on how to estimate the size of the administrative costs and how to determine whether these costs could justify the creation of a sharing mechanism.

3.2.1 How high are the administrative costs?

As outlined in section 2, if ComReg finds an unfair burden, it is required to implement a sharing mechanism to secure funding of that burden from other communications operators. ComReg has consulted on the working of such a sharing mechanism, although to date it has not come to a final decision.[9]

There are many regulatory, administrative and operational costs of establishing and implementing a sharing mechanism. As noted by ComReg, the size of these costs will depend on the precise type of funding mechanism established. The principal functions of a sharing mechanism are apportioning the net cost between operators,[10] collecting the contributions, and distributing them to the USP.

To determine the administrative costs of setting up a sharing mechanism, a number of factors would need to be considered. For example, the fund could be administered by the regulator or by a separate organisation. Regulation 12(2) of the Regulations states that:

> The Regulator shall establish a sharing mechanism administered by it or by a body independent from the designated undertakings, which body shall be under supervision of the Regulator.[11]

In ComReg's consultation on the development of a sharing mechanism, it suggests that it is well positioned and 'has the necessary competency' to administer the USO funding mechanism.[12] Furthermore, given its knowledge and understanding of the administrative issues, it considers that some level of efficiency could be achievable relative to having a separate body run the fund. Indeed, in a number of other countries with sharing mechanisms, the regulator also administers the fund; this is the case, for example, with the French regulator, ARCEP.

Having ComReg administer the fund would be a less costly option, as it would not require a new office with additional overheads. However, it could potentially raise governance issues, as the fund would be internally managed. This issue could be addressed by ensuring that an independent audit of the apportionment and collection of the net cost from operators is undertaken. It would also be necessary to determine whether the fund could be run by existing staff or whether additional employees, responsible solely for the operation of the fund, would need to be taken on.

[9] ComReg (2011), 'Consultation on sharing mechanism for any USO Fund: Principles and Methodologies', 11/77, October 28th.
[10] Under ComReg's proposals, this is subject to the restriction that operators that do not meet a minimum turnover threshold are excluded.
[11] Statutory Instruments (2011), 'European Communities (Electronic Communications Networks and Services) (Universal Service and Users' Rights) Regulations 2011', S.I. No. 337.
[12] ComReg (2011), 'Consultation on sharing mechanism for any USO Fund: Principles and Methodologies', 11/77, October 28th, p. 19.

Precedent from sharing mechanisms in other jurisdictions can also provide some indication of the administrative costs of operating these funds. However, cross-country comparisons should be treated with care, as the sharing mechanisms may be set up in different ways and/or perform diverse functions.

In the USA, the Universal Service Administrative Company (USAC) is an independent, not-for-profit corporation which collects universal service contributions from telecoms carriers and administers universal support programmes under the oversight of the Federal Communications Commission (FCC). In addition, it undertakes the billing, collection and disbursement functions of the universal service support mechanisms. The USAC incurred administrative costs of about $100m in 2011 in order to provide $8 billion in disbursements from over 2,700 contributors, as well as to administer the universal support programmes. As a proportion of the disbursements, the administrative expense rate was 1.3%.[13]

An illustrative analysis has been undertaken of the potential costs of setting up a sharing mechanism, assuming that the fund is administered directly by ComReg rather than through the creation of an independent organisation, based on Oxera's experience of working with regulatory bodies.[14] This analysis suggests that ComReg would require no more than the equivalent of three full-time staff to run the compensation fund. Based on an indicative cost per staff member for comparable work, this indicates that the additional cost of administering the fund should be no more than €150,000–€200,000 per annum, and may be significantly less.[15]

Even if the fund is run internally, there may be costs in addition to staff costs. For example, legal advice or external auditing may be necessary, and additional administrative expenses would be likely, for example for IT and equipment. The impact can be considered assuming that the costs included in ComReg's accounts increase in proportion to the three additional employees required. On this basis, the costs could increase, but would still be highly likely to be no more than €300,000–€400,000 per annum.[16] This includes some costs above the cost of the equivalent of three staff members (for example, to deal with any challenges or to obtain expert advice). While these costs could grow to reflect 'one-off' factors associated with a more complex application, the assumption of three full-time equivalent staff already accounts for a detailed and time-consuming process of analysing the net cost of the USO and the allocation within a sharing mechanism. It would therefore appear highly likely that the cost of even a complex application would remain below €1m.

While these figures may be used for indicative purposes, ComReg would be best placed to assess in more detail the administrative costs of setting up a sharing mechanism, and may come to a different answer on the basis of additional information.

3.2.2 How do these costs compare with the net cost of the USO?

Once the administrative costs are determined, they need to be compared with the positive net cost of the USO. As noted by ComReg, the USP needs to make a proportional contribution to the sharing mechanism based on its eligible turnover. Therefore, the measure for the evaluation should be the size of the potential net transfer to the USP, rather than the overall net cost of the USO.

As demonstrated by the precedent from Italy detailed in section 4, given that the USP is often the former monopoly provider, a sharing mechanism set up in this way may lead to a large proportion of the compensation being contributed by the USP itself. In the case of eircom, and its application for funding of €6.2m, if it were concluded that eircom itself would fund

[13] USAC (2011), '2011 USAC Expenses'.
[14] ComReg (2011), 'Annual Report 2010', December 9th. This was the most recent annual report available in the public domain.
[15] Based on information on salaries in Ireland, taken from www.morganmckinley.ie.
[16] This includes staff costs, pension costs, technical advice, legal expenses, advertising, administrative expenses, auditors' remuneration, premises and related expenses, depreciation, and subscriptions to international organisations. Many of these costs may not be applicable to the costs associated with implementing a sharing mechanism. It excludes the loss on sale of vehicle cost, as this is a one-off cost and unlikely to be relevant in determining the administrative costs of the fund.

50% of any sharing mechanism (as an illustrative example), the net transfers to eircom for the purpose of the administrative cost test would be €3.1m.

3.2.3 Summary and discussion

When assessing the administrative costs, it is important to first estimate the administrative costs of establishing and running a sharing mechanism, and then compare these to the net transfers to the USP.

In determining whether the administrative costs as a proportion of the net cost of the USO are substantial, it is useful to consider ComReg's second test, discussed in the following section. This test, which assesses whether the net cost of the USO has a material impact on the USP, contains a similar analysis looking at the materiality of the net cost—in this case, relative to the profitability of the USP.

Based on the expectation of likely efficient administrative costs as set out above, the administrative cost test would potentially be met by any net cost calculation, which could be as low as €1m. Section 3.3.2 below concludes that the test for a material impact on profitability will result in a higher cost, with the trigger for materiality being potentially in the range of €6m–€22m. Any net cost of the USO that is determined to be material in the profitability assessment set out in section 3.3.2 would therefore also be likely to justify the administrative costs of setting up a sharing mechanism. In other words, if the net cost is material to profitability, it is also likely to be material to administrative costs.

In summary, three steps could be undertaken when implementing this test:

– **estimate the size of the administrative costs** associated with establishing and operating a sharing mechanism, including the costs of labour, overheads and external auditing as relevant;

– **compare the administrative costs with the net transfers to the USP**;

– **consider the materiality test in the context of the assessment of the USP's profitability**—and, for the foreseeable future, if the net cost is considered to be material relative to profitability then it is also likely to be material relative to administrative costs.

3.3 Assessment of the USP's financial position

Decision 40 states that ComReg will assess whether the net cost significantly affects a USP's profitability and/or its ability to earn a fair rate of return on its capital employed. Therefore, in order to determine the outcome of this test, three questions need to be considered:

– is the profitability of the USP indicative that it is not able to earn a fair rate of return on its capital employed?
– if so, is this impact significant?
– if it is significant, is it the net cost that is contributing to such a shortfall in profitability (ie, can the shortfall in profitability be linked to the net cost)?

3.3.1 Does the net cost of the USO affect the profitability of the USP?

One way to evaluate the impact of the net cost on the USP's profitability is to determine how the profit of the USP compares against a range of reasonable profitability benchmarks with and without compensation of the net cost. This is consistent with Decision 40, which states that:

> ComReg will assess whether or not [the] net cost significantly affects a USP's profitability and/or ability to earn a fair rate of return on its capital employed.

For example, assume that, broadly consistent with ComReg's 2008 determination on eircom's cost of capital,[17] the benchmark profit for the USP is an operating profit (ie, pre-tax and pre-financing) measured as a return on capital employed (ROCE) of 7–11%,[18] with a point estimate of 10.2%, and that the net cost is 0.4% of the capital employed associated with the USO. Table 3.1 considers four illustrative scenarios and the effect of the net cost on the USP's profitability in each of them, with and without compensation.[19]

Table 3.1 Illustrative compensation for the net cost of the USO

Scenario	USP's ROCE without compensation (%)	USP's ROCE with compensation (%)	Is the USP able to earn a fair rate of return without compensation?
1	15	15.4	Yes
2	10	10.4	Yes
3	6.8	7.2	No
4	3	3.4	No

Note: The net cost of 0.4% of the capital employed is intended to be illustrative only and is not based on actual data.
Source: Oxera.

In the first scenario, the USP earns a ROCE above the upper bound of the benchmark range with and without compensation for the net cost of the USO. In this case, the USP's profitability is not materially undermined by the net cost.

In the second scenario, the USP earns a ROCE within the appropriate range with and without compensation, although this rises above the point estimate in ComReg's determination for the cost of capital with compensation.

In the third scenario, the USP earns a ROCE below the lower bound of the range, which rises above the lower bound with compensation. As a result, the net cost is likely to have a material impact on the USP's profitability, to the extent that it changes the perceived viability of the provider. As discussed further below, the actual shortfall in profitability relative to the cost of capital would then need to be assessed as to whether it is, in practice, a result of factors relating to the USO.

In the fourth scenario, the net cost may also have a material impact on the USP's profitability, as it earns a ROCE below the lower bound of the range with and without compensation. A number of factors outside the USP's control could lead to this scenario, such as a decline in demand in the market or the entry of a strong competitor. It could also be caused by a shortfall in the efficiency of the operator against the regulator's assumptions and/or other operators. In these scenarios, it would therefore be particularly important to consider whether the net cost has actually caused the shortfall in profitability, as discussed further in section 3.2.3 below.

In summary, while this analysis alone cannot determine whether the net cost has a material impact on the profitability of the USP, it should be able to indicate whether the USP's profitability is within one of three broad ranges:

[17] ComReg (2008), 'ComReg sets new Eircom cost of capital at 10.21%', media release, May 22nd, available at: http://www.comreg.ie/_fileupload/publications/PR220508.pdf.
[18] ROCE is an accounting-based financial metric that captures the relationship between operating profits and capital employed in the business. It is widely used as a measure of profitability in market investigations by the UK Competition Commission and Office of Fair Trading, as well as by the European Commission. See, for example, Office of Fair Trading (2003), 'Assessing profitability in competition policy analysis', Economic Discussion Paper 6, July, report prepared by Oxera; and Competition Commission (2010), 'Movies on Pay TV Market investigation. Profitability of Sky', August.
[19] Table 3.1 includes a wide range of potential outcomes, and, under Scenarios 1 and 4 in particular, it is clear that other prevailing factors, in addition to the USO, are having a material impact on the ROCE achieved by the USP.

– **not undermined by the net cost**: above the range of reasonable profitability benchmarks there may be a net cost, but it is not affecting the USP's ability to make a reasonable commercial return, and is therefore unlikely to represent an unfair burden;

– **potentially undermined by the net cost**: within the range of reasonable profitability benchmarks, the USP could legitimately argue that it should be able to earn the higher returns that it would earn in the absence of any net cost, particularly where its returns have also been undermined by growth in competition (discussed in section 3.4);

– **weak and indicative of a potential threat to the USP's financeability**: below the range there is a clear case for funding the net cost if the other tests are met.

Illustrative application of profitability analysis for eircom—regulatory accounts

As described above, in determining whether the net cost has a material impact on the profitability of the USP, a profitability assessment would need to be undertaken. Oxera has therefore sought to calculate the actual returns achieved by eircom in recent years, and specifically within 2009–10, and then to compare this with the weighted average cost of capital (WACC) range assumed by ComReg in 2008 to cover this period.

ComReg requires eircom to publish regulatory accounts that provide a detailed analysis of how actual returns have compared with allowed returns within the period. Regulators such as ComReg will generally require such regulatory accounts for the purpose of providing a measure for actual profitability that is more relevant in making regulatory decisions. For example, ComReg's 2010 decision on accounting separation stated:[20]

> The purpose of imposing an obligation regarding accounting separation is to provide a higher level of detail of information than that derived from the statutory financial statements of the notified operator, to reflect as closely as possible the performance of parts of the notified operator's business as if they had operated as separate businesses, and in the case of vertically integrated undertakings, to prevent discrimination in favour of their own activities and to prevent unfair cross-subsidy.

Consistent with this, Oxera has first considered the regulatory accounts in coming to a view on the relevant measure of profitability. As part of this analysis, it is also important to determine the scope of business relevant to the assessment, as this could affect the outcome. The threshold could be set with reference to revenues and profitability at the level of:[21]

– **the core 'USO business'**. This would include the regulated wholesale components of eircom's business that operate the USO network, and the related USO retail business.[22] This definition would exclude unregulated wholesale and retail activities, Meteor and other subsidiaries. This definition would be focused on those businesses in relation to which eircom would retain a position of incumbency as a direct result of its position as the USP;

– **the 'fixed-line business'**. This would include all of eircom's integrated fixed-line business, including wholesale and retail, and business and residential, including data communications and interconnect services. Mobile services would be excluded;

– **the group level**. This would include all, or substantially all, activities undertaken by the eircom group, both regulated and unregulated, mobile and retail. In principle, it would

[20] ComReg (2010), 'Accounting Separation and Cost Accounting – Review of Eircom Limited', 10/67, August 31st, p. 14.
[21] Other definitions could be used, and Oxera has not sought to strictly reconcile with the definition of eligible turnover. However, given that these definitions are transparent from eircom's accounts and create a range of potential outcomes, it is considered that they provide an appropriate starting point for the analysis.
[22] As per the Historical Cost Accounts for 2011 and 2012, Oxera assumes that this USO business would include wholesale plus the PSTN retail business.

exclude any businesses that are completely unrelated to the telecoms business, but at present the size of such businesses as a share of total eircom revenue is very small.

Table 3.2 compares the results for the fixed-line business over the period 2006–12. It shows a consistent pattern of profitability, and a review of the regulatory accounts indicates—taking into account a change in reporting requirements effective in 2010–11—that the overall pattern appears to be fairly consistent for the regulated business and the associated retail business.[23] In addition, while the separated retail business is a relatively low-capital business and ROCE may therefore not be the only relevant measure, it is clear that operating profits on regulated activities and the USO retail business have been significant and margins have been consistent over the current control period.

Table 3.2 Return on capital employed for the fixed-line business

	2006	2007	2008	2009	2010	2011	2012
Revenues (€)	2,362	2,960	2,249	2,119	1,906	1,823	1,609
Operating profit (€)	267	264	320	245	305	388	338
Mean capital employed (€)	1,358	1,286	1,278	1,266	1,242	1,484	1,515
Return on capital employed	**20%**	**21%**	**25%**	**19%**	**25%**	**26%**	**22%**

Note: Revenues include both wholesale and retail revenues, and therefore include some 'double-counting' of internal revenues, although these are removed before profit is assessed. Operating profit is calculated as combined revenues less operating costs (including transfer charges from wholesale) and less exceptional cost items. Wholesale revenues include both regulated and unregulated revenues. Meteor, other subsidiaries and other businesses are excluded. Profit for 2006–10 excludes the impact of the 'regulatory rate of return' adjustment made by eircom to its profits to demonstrate a return consistent with ComReg's assumptions.
Source: eircom's HCA separated accounts 2006–12, available at: www.eircom.ie, including the impact of restatements. Oxera has also reviewed the CCA accounts, which indicate a comparable conclusion.

While, as discussed above, there are legitimate alternatives to this definition of the business, this combined definition reflects that part of the business that benefits directly from the USO, and also incurs the costs relating to the USO. Some of the services within this definition of the business are not USO services, and will incur some incremental costs not related to the USO network. Nevertheless, this business also benefits from the presence of the USO network, and many of the network costs used across the business will be shared between the USO and non-USO and regulated and unregulated parts of the business. As a result, the average cost—and therefore the profitability of these businesses—will not be dissociable from that of the USO business.[24]

The regulatory accounts therefore appear to give a clear indication that eircom has been consistently profitable, at the level of the business that has the USO, since 2006. Profit margins for the two alternative definitions have been lower than for the fixed-line business, but well above the upper bound for the allowed return within the 2008 charge control of 11%.

[23] These accounts were significantly reformed in 2010–11, and therefore the returns over the period cannot necessarily be assessed on a strictly like-for-like basis; however, there is little evidence from the data of a change in the trends in 2010–11.
[24] The 'dissociability test' is used in consideration of a range of issues relating to network effects, and can support understanding of the wider economic impact of the USO and benefits. Where such wider effects are directly linked to changes to the USO (either cost or revenues) then they could be considered to be not dissociable from the USO—ie, that the businesses using the USO network cannot be separated from the USO business. In some cases, this may mean that it would be more appropriate to consider the economic effect on the wider network including such dissociable elements of the network than to consider only those activities that are most directly linked to the USO.

Table 3.3 Profitability within eircom's regulatory accounts for different levels of aggregation

Level of aggregation	Turnover (€m)	Profit (€m)	Mean capital employed (€m)	ROCE, 2011–12 (%)
USO business	994	197	1,374	14
Fixed-line business	1,609	338	1,515	22
Group level	1,981	297	1,556	19

Note: All figures reported are for 2012. USO business is proxied by wholesale regulated and retail PSTN and ISDN Access. Fixed-line business includes both regulated and unregulated parts of wholesale and retail businesses. Group level includes Meteor, but excludes other subsidiaries. Exceptional items are excluded from the analysis of returns.
Source: eircom (2012), 'Historical cost separated accounts for the year ended 30 June 2012'.

Tables 3.2. and 3.3 show that eircom has met and generally exceeded ComReg's assumptions for profitability across the areas that are subject to price control regulation, and, in particular, that it has managed to retain significant profitability across the retail markets where such price control regulation has been more limited or removed. As competition develops further, the latter, in particular, may reduce over time.

Should the pattern of returns change across the different businesses described in Table 3.3 above, ComReg would need to give further consideration to the most appropriate choice of the relevant business. While the net cost must be strictly calculated with reference to the scope of the universal service itself, the analysis of its impact on eircom should take into account the relevant parts of its integrated business. This would need to include consideration of the extent to which the finances of the remainder of the fixed-line business—and potentially the mobile business—are affected by the same factors that are causing a net cost, and therefore how eircom's profitability as the USP is best measured. This could relate to either cost factors, including shared network costs within the integrated fixed network, or revenue factors, to the extent that market trends undermining the finances of the USO and resulting in higher net cost also affect eircom's other businesses, either positively or negatively.

Illustrative application of profitability analysis for eircom—statutory accounts

The analysis above is based on eircom's business and accounting methodology within its regulatory accounts. Given that the regulatory accounts are based on accounting rules defined by ComReg in the regulatory regime, it could generally be expected that ComReg would give greatest weight to the profitability estimates calculated based on these regulatory accounts.

However, Oxera has also considered the alternative of measuring the ROCE using data from the statutory accounts, including the separate recording of assets and profits relating to eircom's fixed-line business.[25]

There are two potentially relevant definitions of the statutory accounts:

– **eircom limited.** These accounts include the assets and liabilities of the operating companies, and the profitability and balance sheet recorded within the eircom limited statutory accounts is reconciled back to the HCA regulatory accounts;[26]

– **eircom group financial statements.** The eircom group accounts include the assets and liabilities of the holding company, including significant external debt and goodwill.[27]

[25] Statutory accounts available on eircom's website provide some level of disclosure in the segmental reporting section. Based on this data, the regulated business is best proxied by eircom's fixed-line segment, which includes access (rental and connections), voice and data traffic, data communications, and interconnect services. See company reports and presentations available at http://investorrelations.eircom.net/reports.
[26] See, for example, pp. 70–1 of eircom's 'Historical Cost Separated Accounts for the year ended 30th June 2010'.

With respect to the eircom limited accounts, this reconciliation demonstrates that, while reported performance is different, the scale profitability compares to that within the regulatory accounts when comparing against the assumed cost of capital. For example, in 2009–10, these reconciliations indicate that ROCE was, on a like-for-like basis, approximately 19% at the eircom group level within both the regulatory and statutory accounts.

At the group level, the results can be significantly different, largely due to the inclusion of significant goodwill on the group balance sheet. Depending on the measure of profitability used, this can result in significantly lower ROCE, if either:

– ROCE is measured against the assets allocated to fixed-line, which for 2009–10 included approximately €1.5 billion of goodwill and other intangible assets, resulting in a much higher asset base and therefore lower return on assets; or

– ROCE is measured at the group level after taking into account the financing costs relating to eircom group debt, which reduced reported profit from €292m at the operating level to €47m net profit in 2009–10.

However, to the extent that this financial performance is the result of significant borrowing requirements or wider business activities, it would follow from D04/11 that this would not be relevant to the determination of an unfair burden.[28] D04/11 clarifies that ComReg would not take into account eircom's level of indebtedness in any unfair burden assessment.

In particular, if the choice of financing policy, rather than the obligations under the USO, caused the shortfall in profitability, it would not appear to be consistent with the principle of an unfair burden for other operators to fund such costs through a sharing mechanism. For example, the data based on the statutory accounts includes goodwill within the asset base, which is not included in the regulatory accounts and does not arise as a result of activities relating to universal service provision.

In summary, Oxera would expect ComReg to focus on the regulatory accounts as the primary source for profitability analysis, with the statutory accounts being considered only as a cross-check. Where any differential relates largely to financing costs, as appears to be the case for 2009–10, it would be more consistent with D04/11 to use the results from the regulatory accounts in coming to a view on the presence of an unfair burden.

The role of efficiency

In addition, consistent with the requirements of the Directive and the Regulations, ComReg should consider the impact of efficiency on reported profitability. Specifically, the Regulations require ComReg to:[29]

> consider all means to ensure appropriate incentives for undertakings (designated or not) to provide universal service obligations cost efficiently.

As a result, if there is a net cost identified based on the actual costs incurred by eircom as USP, ComReg should also consider whether the net cost is consistent with the efficient provision of the universal service. For example, in October 2012 eircom announced significant cost reductions, which, it has indicated, will improve its efficiency. If ComReg concludes that costs were inefficient within the relevant period, it would be appropriate to examine whether profits would have been below the range if eircom had been efficient.

For example, in the case of eircom's profitability as summarised in Table 3.2 for the period 2006–12 in the fixed-line business, if ComReg were to conclude that there were inefficiencies in eircom's costs, this could have further reduced eircom's operating costs or the amount of

[27] See, for example, ERC Ireland Preferred Equity Limited, Financial Statements, June 30th 2010.
[28] For example, as summarised in ComReg (2011), 'Decision on the Costing of universal service obligations: Principles and Methodologies', 11/42, May 31st, para 5.27.
[29] See: http://www.irishstatutebook.ie/2003/en/si/0308.html.

capital employed used in calculating profitability for the purpose of the test in Decision 40. Lower costs would mean increased profits, and lower assets would mean a higher return on capital, and therefore either could result in the assumed profitability being higher than the range of around 20–25% indicated by Table 3.2.

In conclusion, where ComReg might find, in future, that there is a material impact on eircom's profitability from the net cost of the USO, it would need to test whether this material impact is not due to inefficient costs, resulting in both the total cost of universal service provision, and therefore the net cost, being higher than the cost if eircom were operating efficiently. Based on the Directive and the Regulations, ComReg might then conclude that the net cost should not be found to be an unfair burden, but instead would represent a burden relating to the inefficiency of the USP.

3.3.2 Is the impact on the USP's profitability material?

Decision 40 further requires that, in addition to finding an impact on the USP's profitability, such an impact should be significant.[30] Further analysis would be necessary to assess whether the impact of the net cost on the USP's profit, identified through the analysis set out above, is material. In the absence of a generally agreed definition of materiality, it is useful to consider precedent from other jurisdictions and organisations.

There appear to be few other regulators that have used the concept of materiality in the context of the net cost of the USO, although regulators do use materiality in other contexts, as follows.[31]

– In its regulatory accounting guidelines, Ofwat, the water regulator in England and Wales, considers that anything over 1% of total annual income, historical cost operating profit or net operating assets is material, although it notes that this materiality threshold is low since it is quite specific to the context.[32] Ofcom also uses 1% of revenues or costs as a materiality threshold in the context of regulatory reporting for postal services.[33]

– In contrast, in the context of reopeners, Ofwat defines any change that affects the company's turnover by less than 2% as trivial,[34] and requires that the aggregate value of the changes exceeds 10% of the company's turnover for a reopener to be initiated. This is arguably a more direct read-across to the imposition of a sharing mechanism to fund the net cost of the USO.

– Companies have argued that Ofwat's threshold is too high.[35] Indeed, other regulators have lower thresholds for changes in certain cost drivers. For example, Ofgem, the energy regulator in Great Britain, has proposed to allow reopeners for gas distribution companies where unanticipated costs breach a materiality threshold of 1% of allowed expenditure.[36]

[30] D04/11 uses both the terms 'material' and 'significant', which Oxera interprets to be interchangeable for the purposes of interpretation and application of the tests.
[31] ANACOM, the Portuguese telecoms regulator, has set materiality thresholds in its assessment of whether the USO implies an unfair burden. Indeed, in 2011, ANACOM determined that the USO should be considered to be an unfair burden where Portugal Telecom's market share (by revenue) in the provision of fixed-line services was lower than 80% and the net cost of the USO was in excess of €2.5m. This was not, however, strictly linked to an assessment of materiality. ANACOM (2011), 'Decision on the Definition of Unfair Burden', July 15th.
[32] Ofwat (2007), 'Regulatory Accounting Guideline 3.06', Operative: Financial Year 2006–07, February.
[33] See http://stakeholders.ofcom.org.uk/binaries/post/1878.pdf.
[34] Ofwat (2010), 'Interim determination model user manual', October, available at: http://www.ofwat.gov.uk/publications/rdletters/ltr_rd1310idokmanual.pdf.
[35] Ofwat (2004), 'Ofwat forward programme 2004–05 to 2006–07', March, p. 32.
[36] Ofgem (2011), 'Decision on strategy for the next transmission and gas distribution price controls – RIIO-T1 and GD1 Uncertainty mechanisms', supplementary annex, March 31st.

Moreover, a number of accounting precedents have been identified that define materiality. For example:[37]

- the International Federation of Accountants has suggested rules of thumb for cut-off values for assessing materiality, while recognising that materiality decisions should not be based solely on them. The cut-off values include:[38]
  - 5% pre-tax profit from continuing operations, or 0.5% of total revenues for a profit-oriented entity;
  - 0.5% of total expenses or total revenues for a not-for-profit entity;
  - 0.5% of net asset value for an entity in the mutual fund industry;
- the Australian Accounting Standards Board also provides quantitative thresholds as guidance for determining materiality. However, it notes that these need to be considered in the context of the characteristics of the entity, as well as other factors. It sets materiality at a higher level, equal to or greater than 10% of the appropriate base amount, unless there is evidence or convincing arguments to the contrary.[39]

Based on these precedents, it seems that 5–10% of profitability, or 0.5–1% of revenues, could be considered a reasonable benchmark for determining materiality in terms of the impact on the USP's profitability. In the context of eircom's current finances, and based on the data within the regulatory accounts, depending on the scope of business under assessment and the relevant period, this would indicate a threshold range of around €6m–€22m for materiality. Where the net cost is close to or within this range, materiality would need to be assessed on a case-by-case basis alongside other tests and criteria.

Table 3.3 above outlined how turnover, mean capital employed and the return on capital employed differ at each of these levels of aggregation.

Table 3.4 provides indicative ranges for the materiality threshold based on the level of aggregation of the company's activities. These ranges are based on the thresholds being set at 5–10% of profitability or 0.5–1% of revenues. In terms of the measure of profitability, the table highlights the difference between the impact based on actual profitability and that based on theoretical profitability assuming ComReg's point estimate of the cost of capital.

Table 3.4 Indicative ranges for materiality thresholds at different levels of aggregation

Level of aggregation	Revenue threshold	Profitability threshold (as % of allowed return)	Profitability threshold (as % of actual return)
USO business	€6m–€11m	€7m–€14m	€10m–€20m
Fixed-line business	€9m–€18m	€8m–€15m	€19m–€39m
Group level	€11m–€22m	€8m–€17m	€18m–€35m

Note: All figures reported are for 2011 (the first year under which the current definition of the regulatory accounts is available). USO business is proxied by wholesale regulated and retail PSTN & ISDN Access. Fixed-line business includes both regulated and unregulated parts of wholesale and retail businesses. Group level includes Meteor, but excludes other subsidiaries.
Source: Oxera analysis, based on eircom (2011), 'Historical cost separated accounts for the year ended 30 June 2011', July.

In principle, Oxera would expect that, under the meaning of Decision 40, materiality measured against a fair rate of return would be the most relevant measure. In practice,

[37] While these precedents define materiality in a different context—ie, in terms of reporting errors—Oxera considers that they are still relevant.
[38] International Federation of Accountants (2004), 'Materiality in the identification and evaluation of misstatements', International Auditing Standard No. 320.
[39] Australian Accounting Standards Board (2004), 'Materiality', Accounting Standard AASB 1031, July.

however, materiality based on actual profitability can also be given some weight in the analysis. In either case, as discussed in section 3.3.1 above, the analysis would need to consider whether the return should be adjusted to reflect any inefficiencies in the costs incurred by eircom with respect to universal service provision.

Based on the ranges in Table 3.4, any application below €6m would be unlikely to meet the materiality test, whereas any application above €22m would be likely to be consistent with a material impact on eircom, to be assessed alongside the other tests in sections 3.3.1, 3.3.3 and 3.4.

3.3.3 Is the net cost causing the shortfall in the USP's profitability?

The analysis in section 3.3.2 above indicates that, based on the data for eircom both for 2009–10 and more generally during the period under analysis, there does not appear to be a material shortfall in the USP's profitability. However, taking a comparable approach to the above analysis on a forward-looking basis, even if there were a material shortfall, it would still be necessary to consider whether the net cost of the USO had actually contributed to it. Specifically, in Decision 40, ComReg states that it will assess whether:

> [the] net cost significantly affects a USP's profitability and/or ability to earn a fair return on capital employed

Therefore, it is not sufficient for there to be a shortfall in profitability; there must also be a link between the net cost and such a shortfall in profitability. For example, if the net cost has existed for many years and economic conditions have not changed, that cost may only now be having a material impact on profitability because the USP has become less efficient (at least by reference to the regulator's assumptions), or it has experienced changes in its business environment more generally.

Such analysis will require consideration of a range of factors that could have caused profitability levels below ComReg's assumptions, and whether these are linked to the criteria for determining whether there is an unfair burden. Consistent with Decision 42, ComReg should look at changes in:

– **the direct USO net cost over time**—given that prices are capped for the price control period, if the net cost increases during the period, the regulatory structure may be contributing to the loss because the USP is unable to raise its prices above the cap. eircom's current application represents the first such application and therefore it will be more difficult to implement this test. Nevertheless, it can be taken into consideration in more detail in any future review;

– **market share over time**—eircom's market share may have declined as a result of changes in the competition in the market. This may indicate both that competition is a driver of the presence of a net cost and that other competitors are well placed to share the net cost. This is considered further in section 3.4 below.

If these factors are present, consistent with ComReg's decision, it is likely that any net cost resulting in a material shortfall in profitability would be found to be an unfair burden.

However, it is also possible that ComReg could find both a material net cost and that the net cost has resulted in a shortfall in profitability, but that these factors are not present. There are other factors that may cause eircom's profitability to fall. The rate of efficiency improvements, relative to either ComReg's assumptions for efficiency improvements in setting any price control, or other operators, could result in a net cost. Alternatively, wider changes to demand factors across the telecoms market, potentially unrelated to the USO or to the development of competition within the USO network, could affect eircom's finances and lead to a shortfall in profitability.

In this case, the analysis of the cause of the net cost may indicate—again consistent with the tests in Decision 42—that the net cost does not represent an unfair burden, as it is not the USO that is causing the shortfall in profitability (ie, there is no causal link between the USO and the net cost). In this case, ComReg may still wish to seek to remedy the shortfall in eircom's profits on a forward-looking basis, through changes to the regulatory environment, without making a finding of an unfair burden.

3.3.4 Summary and discussion

The analysis points towards three conditions that would indicate that the net cost has a material impact on the USP's profitability, and which, if they are all met, could help to establish whether there is an unfair burden that should be funded by a sharing mechanism:

– the impact is material in the context of the USP's revenues and profits, which is likely to mean a minimum of around €6m–€22m for eircom, depending on the definition of materiality and the level of aggregation;

– the impact results in profitability below, or potentially within, the range of assumed profitability for the USP. Based on the 2008 determination, this would mean a ROCE below or within the 7.77–11.08% range;

– the impact is linked to the obligations within the USO, either as a result of an increase in the net cost that cannot be funded by higher regulated prices, or through the impact of competition.

If all these conditions are met then Decision 40 is likely to be met, and the USO will be significantly affecting the USP's profitability. However, as discussed above, this is not sufficient to find an unfair burden, and ComReg would then need to consider Decision 41, which is discussed in section 3.4 below.

Table 3.2 above analysed profitability across the fixed-line business in 2007–12. It shows that over this period, and specifically in 2010 in the context of eircom's current application, profitability was well above the range for allowed ROCE. While measures under different scopes of business might have been lower, Oxera's analysis indicates that profitability (measured on this basis) would still be above the cost of capital.

As discussed in section 3.3.1, this would not be the case for the total return on assets for the business within the group statutory accounts, largely due to the presence of significant goodwill. It is understood that, under ComReg's approach, this would not be considered part of the cost base for the relevant USO business, and therefore that the data in Table 3.2 would be a better indicator of whether there is and has been a significant shortfall in profitability within that USO business.

3.3.5 Implication for eircom's application for 2009–10

Therefore, under the framework established in this section and consistent with ComReg's guidance:

– returns appear to be consistently above the assumed return on capital, and, in particular, were more than 20% for the fixed-line business in 2009–10;

– this would provide grounds for ComReg to find that there is not an unfair burden in 2009–10;

– in this case, the competition test in Decision 41 would not affect this decision; and

– even if the test in Decision 41 were to find that competition had directly caused and resulted in the net cost, where there is no material profitability impact, the approach would not imply an unfair burden.

At the same time, the position with respect to profitability may change in the future, and therefore the next section considers how ComReg could consider the assessment of the competition test in Decision 41 should a future assessment find that Decision 40 is met.

3.4 Competitive distortion assessment

As discussed above, for eircom's application for 2009–10, it may not be necessary to undertake a full review of its data with respect to the development of the competitive market. This is because eircom's profitability in its regulated business does not indicate a material shortfall in profitability. In addition, the absence of a shortfall in profitability potentially makes such a test incoherent, as the aim of the competition test in Decision 41 is to identify a causal link between the development of competition and such a material impact on profitability.

This section therefore considers in principle, rather than in practice, the forms of analysis that ComReg could undertake to perform such an assessment, if there were an identifiable shortfall in profitability, and taking into account the data that would be obtained in the categories identified in Decision 42. As with the profitability assessment, when performing the test in practice, ComReg may also have to consider the different trends in market share for the different scopes of business described in Table 3.3 above.

As part of any test of whether Decision 41 is met, ComReg will need to assess whether the net cost has a material impact on a USP's ability to compete on equal terms with competitors, by considering factors such as changes in market share, prices, and market entry barriers over time. This dynamic analysis of the nature of competition will complement the profitability analysis set out above. For example, even if the net cost of the USO does not have a material impact on the USP's profitability at present, changes in competitive conditions could undermine its ability to internalise the net costs of the USO in future.

3.4.1 Role of the competitive distortion assessment

Section 3.3 has shown how a USO burden could arise without the presence of competition. The USO could impose additional costs on the USP, leading to returns falling below the reasonable commercial rate of return, without competition contributing to this impact.

As discussed in section 2, the legal framework in Ireland prescribes that ComReg can finance an unfair burden only through a sharing mechanism. D04/11 includes a competition test that is designed to assess whether such a sharing mechanism may be appropriate in order to compensate the USP for the competitive disadvantage it faces relative to other non-USP operators as a result of the USO. Decision 41 states:

> If the positive net cost significantly impacts a USP's profitability, ComReg will assess whether or not such a net cost materially impacts a USP's ability to compete on equal terms with competitors going forward.

This is consistent with the economic impact of finding an unfair burden—ie, that, following such a finding, eircom's competitors will be required to contribute to funding the cost of the universal service provision. If the USO did not affect eircom's ability to compete as described then such a requirement would, in practice, be likely to have an impact on other operators' abilities to compete with eircom.

As highlighted in section 3.3 above, analysis of the USP's profitability does not indicate that, with respect to eircom's 2009–10 application, the first part of this test (ie, a significant impact on the USP's profitability) is met. In the absence of a shortfall in profitability, it is, in practice, impractical to test the causes of the shortfall, and in particular whether this results in an inability to compete on equal terms.

Oxera's analysis below considers how the outcome of the competition test could be analysed in principle or in future applications, particularly with respect to the forms of analysis that would be taken into consideration in the context of Decision 42.

3.4.2 What is the impact of competition on the USP?

Following on from the profitability assessment, if eircom's financial position is robust—for example, if it is earning above the reasonable commercial rate of return without compensation for the net cost of the USO—it might arguably be able to absorb some loss of business to competitors and still fund the net costs of the USO internally. However, if its financial position is not so strong, a significant loss of revenue to competitors could render it unable to earn a return consistent with the range identified in section 3.3, and unable to cross-subsidise the USO. Thus, changes in the historical market share of the USP and its key competitors can be explored to determine whether competition is having a negative impact on the USP's revenue, or whether other factors, such as a decline in the overall market or the USP's lack of efficiency, could be responsible.

Box 3.1 below presents an illustrative example of the type of market share analysis that ComReg could undertake to provide evidence for the competitive distortion assessment. In particular, it could use this analysis to determine the loss of market share over the period under consideration. Ideally, this analysis would be undertaken based on the chosen metric that is used to determine contributions to the sharing mechanism. However, in the absence of a decision on the sharing mechanism, this example has considered the total turnover of operators. Note that ComReg might reach a different conclusion on the basis of different data that it could seek to obtain from operators.

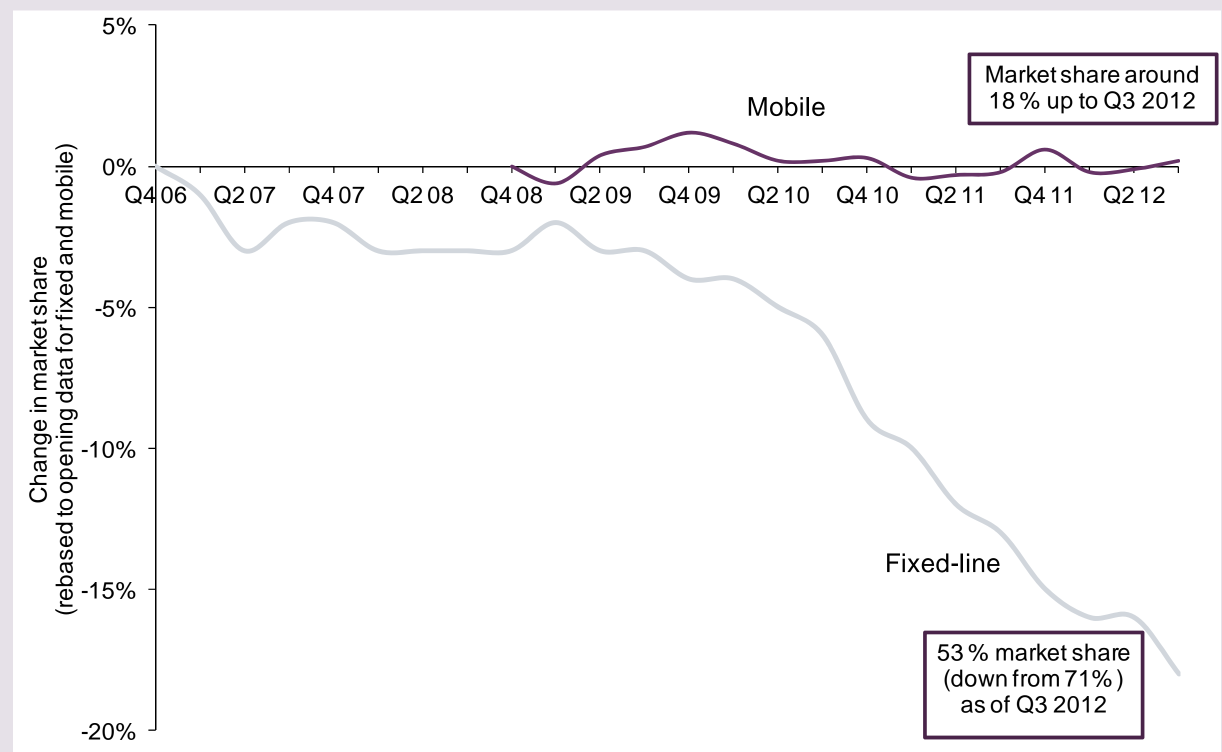
Box 3.1 Illustrative market share analysis

As illustrated below, eircom's market share (by revenue) in fixed-line telecoms declined by 2% over 2009–10 and by 14% between 2007 and 2011. The percentage of total industry revenue from fixed-line telecoms remained relatively stable between 2007 and 2011, although the combined fixed-line revenues of all operators in the market declined.

Other competitors have also gained significant market share. UPC had no market share of the fixed-line market at the end of 2008, but achieved nearly 7% by the end of 2011. Overall, the number of competitors with more than a 2% market share increased from three to six over this period.

While not conclusive, the figure below is indicative of an ongoing decline in eircom's market share, which may indicate that any shortfall in profitability is due to eircom being unable to compete. This would need to be considered alongside the analysis below, which tests the extent to which there is a link between any fall in market share and any fall in profitability.

It is also useful to consider eircom's market share (by revenue) in the mobile market. As discussed in section 3.3.1 above, such revenues may not be included in the analysis of the USP's profitability for Decision 40. Nevertheless, such mobile revenues are proposed to be included in the eligible turnover used to calculate contributions to the sharing mechanism, and this market share has been relatively stable, fluctuating between 17% and 19% over the period from 2009 to 2011.



Note: Mobile data was not available for eircom before Q4 2008.
Source: eircom (2009), 'Fourth Quarter and Twelve-month Results to 30 June 2009', August 27th; eircom (2010), 'Second Quarter and Six-month Results to 31 December 2009', February 25th; ComReg Market Information quarterly reports, available at: http://www.comreg.ie/publications/market_information.539.0.100011.0.p.html.

Even if the USP's market share has remained relatively stable over the past few years, there may be significant prospects for entry and few market entry barriers. If there is a significant net cost with appreciable entry, this might indicate that the USP is more likely to face an unfair burden than if the net cost were low relative to the scale of prospective entry. As demonstrated by the international precedent in the following section, a number of regulators employ a market share threshold: if the USP's market share drops below the threshold, the net cost is considered to be an unfair burden. While dominance thresholds from competition law could be employed, this type of analysis in isolation does not take account of causality. For example, the USP's market share may have dropped below the threshold as a result of factors unrelated to the USO and which do not result in an unfair burden. While the USP's

market share may be declining, it is important to consider whether competition is having an impact in the most profitable segments of the market, as discussed in the following section.

An indicative analysis of whether it is the increase in competition that has caused the decline in profitability would potentially use ComReg's own regulatory decisions combined with the additional analysis from Decision 42. In other words, it would need to address the following.

– **What did ComReg assume regarding the development of competition?** ComReg's current regulatory framework[40] assumes that competition will develop over time but also that prices are set at levels such that eircom is able to earn a fair return on capital after taking into account the impact of any changes on its competitive position.

– **How has the actual development of competition compared with ComReg's assumptions?** Where competition has exceeded ComReg's assumptions in setting the charge control and regulatory framework, this is likely to result in an adverse impact on eircom's finances.

– **Has the development of competition had an impact on eircom's pricing relative to ComReg's assumptions?** As discussed in section 3.3, one of the impacts of changes in market conditions may be that prices have not followed the path expected by ComReg in considering eircom's financeability, and competition may therefore have resulted in a revenue impact due to volume or pricing effects.

– **Does any shortfall in eircom's profitability correspond to the impact of changes in market share?** How does such analysis of any adverse impact on eircom's finances from competition compare with any shortfall in profitability identified in section 3.3?[41] Where profits are lower than anticipated, does this appear to be linked to the changes in market share, or does it relate to efficiency or other changes in market conditions (ie, reduced revenue in the relevant markets for all operators)?

This analysis should provide a guide as to whether there is a case that competition has contributed to any significant shortfall in the USP's profitability, consistent with part of the test in Decision 41. The remainder of the test—whether the USP is able to compete on equal terms with competitors in future—is considered next.

3.4.3 Is the USP able to internalise the net cost of the USO?

The market share analysis above is relevant because when there is little or weak competition, the USP may be able to self-finance through internal cross-subsidisation; the profits from the economic (profitable) areas can be used to finance any losses in the uneconomic (loss-making) areas that the USP is required to serve as part of the USO. Indeed, ComReg's guidance suggests that price uniformity is one of the factors that can help to determine whether the USO creates a competitive disadvantage for the USP.

However, it is also important to determine the nature of competition and, in particular, the specific segments of the market that are affected by it. For example, if competition is focused on the most profitable segments of the market, this would be more likely to create difficulty for the USP in cross-subsidising uneconomic areas. As noted in ComReg's consultation on the sharing mechanism:

> if for example a USP were operating under a monopoly position any funding of a positive net cost could be sustained through cross-subsidies from profitable customers to unprofitable customers (which may not be served in the absence of the USO). A monopoly position can protect a USP's financial stability and enable it to provide the

[40] Specifically, the current framework for the regulation of access, the USO regulations and the price controls imposed on eircom.

[41] This would include, for example, analysis of the extent to which any change in market share focused particularly on profitable customers, and therefore the extent to which eircom as the USP is retaining the subset of customers who are more expensive to serve and therefore potentially less attractive to competing operators.

> USO over the fixed telephone network. However, if a USP is facing a growing presence of alternative providers in the most profitable segments of the market, its ability to cross-subsidise USO customers may be undermined and could eventually impact on the USP's ability to bear a positive USO net cost.[42]

As such, it would be important to consider the effect of competition on the USP's financial position and, in turn, its ability to internalise the net cost through cross-subsidisation. This could be done by estimating the USP's loss of customers, through the type of market share analysis set out above, multiplied by the average profit per customer. This would help to isolate the profit loss due to increased competition, which is important as there may be a number of factors other than competition affecting the USP's ability to engage in cross-subsidisation. The estimated lost profit from competition could then be compared with the net cost of the USO in order to determine the effect of competition on the USP's ability to internalise the net cost.

In this context, as discussed in section 3.3 and set out in ComReg's Decision 42, it would also be relevant to look at changes in the USP's pricing over time. The USP's ability to raise prices in profitable areas to subsidise loss-making areas is constrained by the price control. However, where there is a uniform pricing requirement, the price cap should allow the USP to sustain a cross-subsidy. If ComReg finds that there is a net cost and a shortfall in profitability, this could be assessed through comparison of:

- trends in average prices and unit revenue generally; and
- trends in average prices in areas and unit revenue in markets served only by the USP.

As a result, ComReg could assess whether any shortfall is being driven by changes in revenue and price trends in the competitive areas, which would indicate that the USO is driving these obligations. This could also be assessed by a disaggregation of the USP's profitability beyond the level of disaggregation outlined in section 3.3. The USP's profitability, at both the retail and wholesale level, could be split into those parts of the network where it retains significant market share, and those where its market share has been eroded due to competition. The profitability in each area can then be considered separately. This could be as a result of different patterns of entry in different markets, or within different geographic areas.

The presence of an unfair burden is most likely to arise where competition has emerged in lower-cost areas and profits have fallen towards or even below the cost of capital, and therefore the USP is unable to earn profits to cover the costs of operating in higher-cost areas.

In determining whether any market distortion caused by competition results from the requirements of the USO and is therefore consistent with finding an unfair burden, ComReg would need to consider the nature of competition during the different segments of the market with different market conditions. This form of analysis could be undertaken by segmenting areas where the USP retains greatest market power from those where there is most competition, for example by splitting the business as described in Box 3.2 below.

[42] ComReg (2011), 'Consultation on sharing mechanism for any USO Fund: Principles and Methodologies', 11/77, October 28th, p. 8.

Box 3.2 Potential segmentation of business for analysis of USO trends and market distortion

Separation by geography	Wholesale split	Retail split	Measures
Dublin	Wholesale Fixed Narrowband Access	Retail residential: Local and national	Volume
Other urban	Wholesale Unbundled Access	Retail residential: International	Price
Rural	Wholesale Broadband Access	Retail residential: other	Cost
	Wholesale Leased Lines	Retail business	Profitability
	Wholesale Call Origination		Market share
	Wholesale Call Transit		
	Wholesale Call Termination		
	Wholesale Residual (Regulated)		

Source: Oxera.

In assessing whether trends appear to be pointing to an increase in market distortions, ComReg could consider, for the different sources, where there are changes that will undermine the USO net cost. In principle, to support an unfair burden, such changes need to be sufficient to result (in combination) in an impact comparable in scale to the net cost. In other words, they are likely to result in markets where there is an identifiable USP profit shortfall calculated as follows:

- USP profits: total net benefits in SMP areas where return > cost of capital; less
- USP shortfall: net cost in USO areas where return < cost of capital.

If such a net shortfall exists and is increasing in markets where the USP's market share is declining, this is likely to be indicative of an unfair burden.

This breakdown of the data is not all readily available. However, the detailed bottom-up cost modelling undertaken by eircom in the preparation of its regulatory accounts, and as used in the analysis of the net cost of the USO by eircom, could be used to produce this form of data. Such analysis could be undertaken on a prospective basis, to inform analysis of future applications by eircom.

3.4.4 Impact of a sharing mechanism on the competitive market

As discussed above, Oxera's analysis indicates that there is currently no evidence of a material shortfall in eircom's profitability, but it also shows that this could change in future if eircom's market share were to continue to fall and if this starts to result in profit falling towards or below the cost of capital.

This section considers the final test that ComReg may need to consider before reaching a finding of an unfair burden. In particular, as explained in section 2.3, where ComReg finds that there may be an unfair burden, but that the evidence from some or all the tests is unclear, ComReg would potentially need to consider the effects in the round. Such an analysis should also consider the consequential impact of a finding of an unfair burden on the competitive market, as discussed in this section.

The presence of a USO net cost implies a market distortion, either where the USP's costs are higher than they would be in a competitive market, or where the USP is required to offer a structure of prices (price uniformity) which would not be applied by a competing operator.

If ComReg finds that the USO net cost represents an unfair burden, this will result in the implementation of a sharing mechanism, which will, in principle, also create a market distortion by imposing additional costs on other operators competing with the USP. In assessing the overall impact of any future finding that may be an unfair burden, ComReg would therefore need to consider how such a sharing mechanism might affect the market.

If other operators are required to contribute to a sharing mechanism, it would be important to consider how this might affect their behaviour and, more generally, competition in the market. For instance, requiring a contribution to the sharing mechanism could prevent or deter some operators from entering or expanding in the market, with the consequence that the USP may actually earn higher profits than it otherwise would have done in the absence of a sharing mechanism.[43]

Such an analysis is complex and would potentially need to consider several factors relating to market conditions. However, as a first test, ComReg could consider the profitability of the operators that are potentially subject to a sharing mechanism (both before and after the impact of such a mechanism). Where the introduction of a mechanism would largely even out existing market profitability, this may indicate that it would resolve existing market distortions. By contrast, if all operators are earning comparable profitability (and this is below equilibrium levels), this could indicate that the introduction of a sharing mechanism would, in practice, increase market distortions and give the USP an unfair competitive advantage.

This could be considered using two sources of data, both as indicated in ComReg's Decision 42:

– **relative operator profitability**, both before and after the effect of a sharing mechanism;

– **market entry barriers**, and whether these are likely to increase as a result of the sharing mechanism, or whether it will ensure that barriers are not artificially low due to the USO.

Such analysis would be based on data comparable to that published by ComReg in its quarterly reports on the communications market.[44] Equally, the adverse impact of any unfair burden on the finances of the USP may be focused on particular markets or market segments, and other competing operators may have higher comparable profitability than the USP. It could therefore be particularly appropriate to find an unfair burden which results in a sharing mechanism that levels the playing field in such markets or market segments between the USP and its competitors.

3.4.5 Summary

In assessing whether the net cost of the USO is affecting the USP's ability to compete on equal terms with other operators, and, as such, whether an unfair burden should be found, with the consequent impact that a sharing mechanism would be established, there are a number of factors to which ComReg may have regard. These would be based on the approach in Decision 42 of ComReg's Decision 04/11, and would include:

– the extent to which the market share of the USP is declining, and the potential for further decline that is not a result of factors such as poor efficiency;

– as a result of declining market share, the fact that the USP cannot internalise the net cost of the USO, possibly because the proportion of the market where the USP retains a monopoly is limited;

– the relative operator profitability between eircom and other operators and the potential impact on market entry barriers of the finding of an unfair burden (and the consequent implementation of a sharing mechanism).

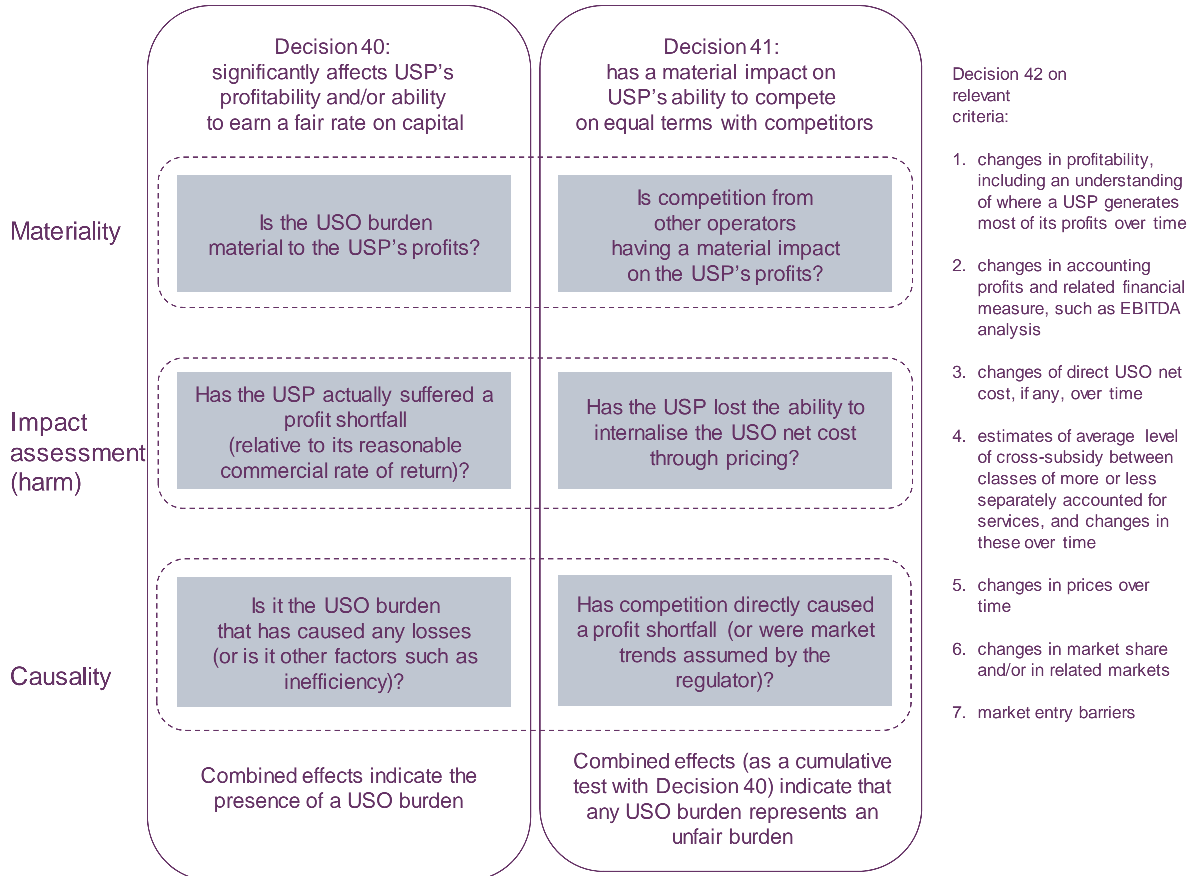
As discussed at the start of this section, these tests will be easier to consider in practice in the context of an actual shortfall in profitability, and therefore in assessment of the link between that shortfall in profitability and eircom's position within the competitive market.

[43] See, for example, Gautier, A. and Wauthy, X. (2010), 'Competitively Neutral Universal Service Obligations', Centre de Recherche en Economie Publique et de la Population, November, p. 3.
[44] Available at http://www.comreg.ie/publications/market_information.539.0.100011.0.p.html.

3.5 Summary of Oxera's proposed framework for assessment of the presence of an unfair burden

The above analysis has examined various factors that may indicate the presence of an unfair burden. However, as these may not all be present at once, the proposed approach would be to consider the factors together in order to draw a conclusion about whether the net cost imposes an unfair burden on the USP, as illustrated in Figure 3.1.

Figure 3.1 Cumulative tests for ComReg in assessing the presence of an unfair burden



Source: Oxera.

Figure 3.1 indicates that two tests, the burden and the competition tests above, should be met in order for the powers under Irish legislation to be enacted, and therefore that a sharing mechanism should be established.

First, regardless of the role of competition in causing any burden, ComReg should determine whether there is a material burden (ie, impact on profitability) caused by the presence of the USO with a harmful effect on the USP.

If this test is met, the second test—whether competition has contributed to the impact of that burden—should be undertaken. If competition has contributed to the net cost of the USO, this would indicate that an unfair burden is present, and therefore that a sharing mechanism is appropriate.

In the context of eircom's 2009–10 application, if ComReg were to follow this framework as outlined in this section, the conclusion would be likely to be as follows.

– **Is the USO burden material to eircom's profits?** The application by eircom for €6.2m is at the bottom of the range of materiality, as defined above. This could be considered alongside the outcome of other tests.

– **Has the USP actually suffered a shortfall in profits?** On the profit measure proposed above, relating to operating ROCE as a proportion of assets at regulatory value, this test is not met.

– **Is it the USO that has caused any shortfall in profits?** Not applicable. In the absence of losses suffered by the USP, the cumulative tests cannot be met, and there is no shortfall in profitability to be linked to the USO.

– **Does the USO have a material impact on eircom's ability to compete?** Not applicable. Again, in the absence of a shortfall in profits, there is no need to test whether this is due to a distortion to competition.

For the avoidance of doubt, as explained in section 3.3.3, following completion of this process, ComReg may find that there is both a material net cost and a shortfall in profitability, but that this does not result in an unfair burden. This could be, for example, where pricing assumptions failed to reflect changes in market demand conditions, or where ComReg made unit cost assumptions that were significantly different to the realised costs faced by eircom.

Where ComReg finds such a material net cost but no unfair burden, there is no alternative mechanism for addressing the past impact, but there would be potential alternative regulatory responses to address the impact on profitability on a forward-looking basis, including but not limited to:

– **reviewing price control regulation**—for example, if there is a net cost but no unfair burden as the net cost has not been linked to the presence of competition, it may be appropriate to allow the USP to increase those prices subject to price controls within the integrated fixed network business (subject to eircom being able to raise prices in the face of competition and the requirement to maintain affordability of USO services);

– **changes to USO requirements**—if the net cost were to increase due to reduced use of USO services and therefore lower incremental revenue, should the scope of the USO be reviewed?

Should ComReg find an unfair burden on the basis of the analysis of eircom's costs, it would also potentially be relevant to consider whether such regulatory responses would be appropriate as a way of reducing the potential for a burden to arise in the future.

3.6 Summary

This section has considered the application of ComReg's tests set out in its Decision D04/11. Oxera has provided an indication of how ComReg could assess the materiality and impact of the net cost of the USO on the USP in response to an application for funding, such as that received from eircom.[45]

In practice, the cumulative nature of the tests, and the need to create a link between the net cost of the USO and any impact on the USP's profitability, mean that there is a strong constraint on ComReg's ability to find that there is an unfair burden that justifies setting up a sharing mechanism.

[45] ComReg (2012), 'Universal Service Obligation: Application for funding from the Universal Service Provider for the period 2009/2010', 12/57, June 1st.

4 International precedent

The concept of an unfair burden is not defined in European Commission Directives or Regulations. The Commission also does not prescribe how regulators should determine whether an unfair burden exists. Instead, as noted by ComReg, and as set out in a 2010 European Court of Justice (ECJ) judgment, the Directive provides national regulatory authorities with discretion in determining what constitutes an unfair burden:

> it falls to the national regulatory authority to lay down general and objective criteria which make it possible to determine the thresholds beyond which...a burden may be regarded as unfair.[46]

The Directive states that the existence of net costs of the USO should not automatically give rise to a right to compensation, and that it is important to determine whether the net cost does indeed represent an unfair burden for the undertaking in question.[47] However, if an undertaking is subject to an unfair burden, a compensation mechanism should be set up to share the net cost of any USO between relevant providers.

Given that regulatory authorities can interpret the concept of an unfair burden at their discretion, they tend to differ in how they determine whether the net cost represents an unfair burden and whether to provide compensation. As such, it is of interest to consider regulatory precedents from other jurisdictions. Table 4.1 presents a high-level summary of a selection of relevant precedents. The sections below provide more detail on the precedent, to the extent that this was available.

Table 4.1 Summary of international precedent

Name of USP	Country	Approach
PTC	Portugal	Financial and competitive analysis to determine whether the USP can internalise the net cost of the USO, combined with analysis of whether the USP's market share is less than 80% and the net cost is greater than €2.5m
Telefónica	Spain	Consideration of general market conditions, the USP's market share and financial analysis
France Telecom	France	Compares the net cost against the company's financials and the costs of implementing and managing the sharing mechanism
Telecom Italia	Italy	Analysis of the USP's market share relative to other operators and consideration of development of competition in the market
BT	UK	Considers the cross-subsidisation between the economic and uneconomic areas
Belgacom	Belgium	Any net cost incurred is considered to be an unfair burden

Source: Oxera, based on regulatory precedents.

The precedents demonstrate that regulators vary considerably in their approaches to determining whether the net cost of the USO represents an unfair burden, and the size at which the net cost has been determined to be an unfair burden. In addition, regulators differ in how frequently they undertake the reviews: some are annual; others are less frequent.

[46] European Court of Justice (2010), *European Commission v Kingdom of Belgium*, Case C-222/08, October 6th.
[47] Directive 2002/22/EC of the European Parliament and of the Council of March 7th 2002, *Official Journal of the European Communities*, April 24th.

4.1 Portugal

Having recently examined whether the net cost of the USO represents an unfair burden for PTC, ANACOM (the national communications authority) noted that it is important to take the degree of competition in the market into account when defining the unfair burden. If the USP has sustained high market shares, and the market is not competitive, ANACOM considers that the net cost of the USO does not represent an unfair burden.

The regulator considered a number of financial metrics, including net income, EBITDA margins, return on investment and ROCE. While most of these were stable between 2001 and 2007, the regulator noted that they showed significant declines in 2008 and 2009. For example, the EBITDA margin was relatively stable at 38–44% between 2001 and 2007, but declined to 32% in 2008 and 20% in 2009.

ANACOM also suggested that, to assess whether an unfair burden actually exists, the moment from when the USP ceases to be able to internalise the net cost of the USO due to market conditions needs to be pinpointed. For example, ANACOM noted that for many years PTC was able to keep its market share at relatively high levels without lowering prices below the price cap, while internalising the costs of the USO. However, if effective competition develops in profitable areas, the USP may be forced to lower prices and margins to sustain competitiveness, and is thus unable to internalise the costs.

Therefore, ANACOM notes that it would be important to take account of the degree of competition in the market, as this may affect the USP's capacity to bear conditions that are far from standard commercial practice with which it must comply in other areas where there is effective competition. An assessment showed that PTC had a market share of over 80% between 2001 and 2006, but that this declined in each year from 2006 to 2009 due to structural changes in the market.[48]

Overall, ANACOM considers that the provision of the USO constitutes an unfair burden when:

- the USP's market share, calculated annually according to the revenue of the fixed-line service, is lower than 80%. ANACOM believes that this approach, used in many other European countries, is more relevant than the Commission's 75% threshold for super-dominance;
- the net cost is €2.5m or more, which accounts for the fact that PTC will contribute to the fund and the costs of implementing and managing a financing mechanism.

Based on fulfilling these conditions, as well as ANACOM's analysis of the evolution of the market's competitive situation and the ability of the USP to internalise the net cost through a consideration of the economic and financial situation, ANACOM considered that 2007 should be regarded as the year since when the net cost of the USO has represented an unfair burden for PTC.

4.2 Spain

In each year between 2000 and 2002, the Spanish telecoms regulator CMT determined that, even though there was a net cost of the USO, it was not an unfair burden. Based on an analysis of market developments and competition—including market share, average revenue per user (ARPU), EBITDA compared with that of competitors and annual profitability—CMT determined that the USP did not incur a significant competitive disadvantage on account of provision of the USO. However, in each year between 2003 and 2005, CMT determined that the net cost represented an unfair burden for Telefónica. CMT based its decision on the

[48] Market shares are based on a fixed-line service. ANACOM (2011), 'Decision on the Definition of Unfair Burden', July 15th.

USP's significant loss of market share since 2002, the worsening of its financial ratios, and increasing fixed-to-mobile substitution.[49]

Since 2008, the funding mechanism in place has consisted of a National Fund for Financing USO, whereby CMT determines annually which operators should contribute to the fund. These operators have complained to the regulator that all operators should have to contribute.[50]

4.3 France

Since 1998, the net cost of the USO has been acknowledged as an unfair burden for France Telecom. These net costs have declined from €275.3m in 1998, to €125m in 2002 and €30.9m in 2005.[51] ARCEP's 2006 report states:

> the existence of a net cost leads to the possibility of compensation only in cases where it constitutes an unfair burden on an operator. It was the Authority's view that, in light of the definitive costs for 2005, such was the case and the implementation of a compensation mechanism was therefore justified.[52]

The regulator assesses whether the net cost is an unfair burden based on various elements, including:[53]

– the net cost versus the financials of the business;
– a comparison of the value of the net cost to the implementation and management costs of the financing mechanism.

4.4 UK

Oftel/Ofcom reviewed the costs and benefits of the USO for BT for the years 1996, 1999 and 2005. In 1996, Oftel determined that BT incurred £45m–£65m in costs and £102m–£151m in benefits from its position as the USP. The regulator estimated that these costs were equal to 0.2–0.3% of industry turnover. Overall, it considered that there was no demonstrable net burden, although it noted that this did not mean that there would never be an unfair burden.[54]

In 1999 Oftel estimated the cost of uneconomic customers to be between £53m and £73m and the benefits to be approximately £61m–£62m, based on updated methodology and cost drivers compared with the calculations previously undertaken. Oftel noted that these calculations excluded factors placing downward pressure on the cost of the USO, including greater efficiency by BT, although it took into account the extent to which BT was unable to recover its costs of serving uneconomic customers from the profit it made from economic customers. Oftel noted that its view was that, based on BT's current return on capital and given the prevailing price control, 'a net cost within the range of estimates we have seen to date is unlikely to be seen as an unfair burden' and 'therefore a more thorough costing exercise was not justified.'[55]

In 2005, Ofcom assessed the extent to which the costs and benefits of the USO to BT had changed since the previous review. It first evaluated whether customers and services were uneconomic for the USP to serve, and then considered the benefits based on an assessment of how BT's financial performance would be affected if the provider lost USO status. The benefits were then subtracted from the costs to determine the net cost. Ofcom estimated

[49] BEREC (2010), 'BEREC Report on Universal Service – reflections for the future', June; ANACOM (2011), op. cit.
[50] Ibid.
[51] WIK-Consult (2008), 'Methodology for calculating the net cost of PTC's universal service obligation (USO) and the definition of an "excessive burden"', July 16th.
[52] Ibid.
[53] ANACOM (2011), op. cit.
[54] Oftel (1999), 'Universal Telecommunication Services', July.
[55] Oftel (2000), 'Review of universal telecommunication services', September.

USO-related costs of £52m–£74m and benefits of £59m–£64m. It considered that it was unlikely that this created an unfair financial burden on BT.[56]

Overall, in each case, Oftel/Ofcom concluded that BT suffered no excessive burden, since the market benefits were greater than the net cost of the USO.

4.5 Italy

For the year 2000, the Italian telecoms regulator, AGCOM, determined that the net cost of the USO represented an unfair burden for Telecom Italia. The regulator carried out an economic survey aimed at 'defining the competitiveness level in telecommunications through a structural assessment of the relevant markets'.[57] It determined that there was a significant increase in the number of active operators in the market for fixed-line services combined with a decline in Telecom Italia's market share.

Based on an assessment of the net cost of €58.9m, Telecom Italia and Telecom Italia Mobile were responsible for €46.9m of this net cost, while they received compensation for €12m from two other operators through a sharing mechanism.[58]

In 2001, AGCOM again determined that the USO net cost represented an unfair burden for Telecom Italia, basing its decision on the degree of competitiveness of the telecoms market and its determination that competition had become more effective. AGCOM determined that there was a net cost of €40.5m, of which Telecom Italia received compensation for approximately a quarter from other operators through the sharing mechanism.[59]

4.6 Belgium

The Belgian Parliament acts as the national regulatory authority which determines whether an unfair burden exists as a result of the USO. All operators in Belgium that provide public telephony services are required to offer social tariffs. The net cost of the USO is calculated as any loss of revenue resulting from the granting of social discounts. In other words, any net cost incurred by an operator is considered an unfair burden and compensation is paid through a fund. As stated in Belgian legislation:

> the net cost of social tariffs for universal service shall correspond to the difference between the revenue which social tariff providers would earn under normal commercial conditions and the revenue which they receive as a result of the reductions for social tariff beneficiaries provided for in the present Law.[60]

For 2003, IBPT (the Belgian regulator at the time) determined that Belgacom incurred a net cost of the USO equal to €48.4m.[61]

In 2008, Belgium was referred to the ECJ by the European Commission based on two complaints regarding its calculation of the net cost and determination of the unfair burden. In particular, the Commission was concerned about the absence of Belgian legislation requiring the regulator to examine whether the obligation to offer social tariffs represents an unfair burden and the method used to calculate the net costs. The Commission concluded that the

[56] Ofcom (2006), 'Review of the Universal Service Obligation', March 14th.
[57] Official Journal of the Italian Republic (2002), 'Universal service: applicability of the net-cost assessment and allocation mechanism for year 2000', January 4th.
[58] Ibid.
[59] AGCOM (2002), 'Universal service: applicability of the net cost allocation and valuation mechanism for the year 2001', December 20th.
[60] Article 45a of the Annex to the Law of June 13th 2005.
[61] WIK-Consult (2008), op. cit.

Belgian system does not observe the principles of cost-effectiveness, efficiency, objectivity, non-discrimination and minimum disruption of competition.[62]

The ECJ ultimately concluded that Belgium had not complied with Directive 2002/22/EC, noting that it did not set out the criteria that it uses to determine whether the unfair burden gives rise to a right to compensation, and that it did not take intangible benefits into account in calculating the net cost of the USO.[63]

4.7 Summary

The above precedents demonstrate that many regulators employ criteria and tests similar to those used by ComReg for determining whether there is an unfair burden. Each of the administrative costs, profitability and competitive distortions assessments is undertaken in at least one other jurisdiction, although no regulator appears to apply all three criteria in tandem. The regulators also tend to take different approaches, including different frequencies of assessment and in relation to the level at which a net cost is determined to be an unfair burden.

Indeed, in a survey by BEREC, the body of European regulators for electronic communications, regulators identified several factors that they may consider in assessing the unfair burden. Many of these relate broadly to market conditions and the degree of competition, and have been cited as being used by regulators in the precedents set out above. These include:[64]

- costs and revenues, as well as the ratio between net cost and revenues;
- traffic volumes;
- the number of subscribers;
- the financial position of the operators;
- market shares. In a number of countries, if the USP has more than 80% market share by revenue in the market for access provided at a fixed location, the provision of the USO is not deemed an unfair burden;
- analysis of the retail and wholesale (interconnection) market, with reference to both fixed and mobile services, including the degree of fixed-to-mobile substitution.

[62] European Court of Justice (2010), *European Commission v Kingdom of Belgium*, Case C-222/08, October 6th.
[63] Ibid.
[64] BEREC (2010), 'BEREC Report on Universal Service – reflections for the future', June.

5 Conclusion

Oxera has proposed a number of specific tests in the context of Decision D04/11 that ComReg could apply to address the question of whether the USO net cost represents an unfair burden. These comprise:

– **materiality tests**—where the net cost must be shown to represent a cost sufficient to justify an intervention through an unfair burden finding, rather than this being seen as part of the normal risks of operating the incumbent network, and also to be material to the administrative cost of implementing a sharing mechanism;

– **profitability and causality tests**—where the net cost can represent an unfair burden only if it, or the presence of competition linked to the USO, has actually resulted in a shortfall in eircom's profitability in relevant markets;

– **competition tests**—where the net cost represents an unfair burden if it affects the USP's ability to compete on equal terms.

ComReg's decisions and the subsequent tests cover a wide range of factors relevant to the finding of an unfair burden and, as such, may not all be met at once, or may indicate different conclusions. Oxera therefore proposes that the outcomes from the assessments be considered together in reaching a conclusion on the net cost of the USO.

In particular, in order to determine whether the net cost of the USO represents an unfair burden, there must be a material impact on the ability to earn a fair rate of return caused by the presence of the USO with a harmful effect on the USP, and competition must have contributed to the impact of that burden. These two requirements are clearly outlined in Decisions 40 and 41 of D04/11 on the calculation of an unfair burden.

At the same time, while these requirements are clearly laid out in the Decisions, in some areas the evidence may not be conclusive. For example, there could be a range of potential outcomes for the impact of the net cost on the USO profitability that are both large enough to be potentially material, but not large enough to be clearly material. In this context, it would be important that an overview is taken of the evidence from Decision 42 and the materiality, causality and competition tests, to determine whether the combined effect represents an unfair burden.

In that context, and given that the tests are cumulative in nature, there is a clear need to create a link between the net cost of the USO and any impact on the USP's profitability. Section 3 highlighted that, in the case of eircom's application with respect to 2009–10, there is no clear impact on the USP's profitability. Therefore, using this framework, ComReg would not be able to show either a direct impact on profitability or a link between that impact and developments in the competitive market. This would therefore indicate that the tests are not met either individually or cumulatively, and therefore that there is not evidence of an unfair burden that would result in the implementation of a sharing mechanism.

Park Central
40/41 Park End Street
Oxford OX1 1JD
United Kingdom

Tel: +44 (0) 1865 253 000
Fax: +44 (0) 1865 251 172

Stephanie Square Centre
Avenue Louise 65, Box 11
1050 Brussels
Belgium

Tel: +32 (0) 2 535 7878
Fax: +32 (0) 2 535 7770

200 Aldersgate
14th Floor
London EC1A 4HD
United Kingdom

Tel: +44 (0) 20 7776 6600
Fax: +44 (0) 20 7776 6601

www.oxera.com