GSM Europe
The European interest group of the GSM Association
http://www.gsmeurope.org

GSM EUROPE[1] RESPONSE TO THE ERG'S CONSULTATION ON FL-LRIC COST MODELING

GSME is pleased to be able to respond to the European Regulators Group (ERG) consultation on a common position to FL-LRIC cost modelling. The *'Principles of implementation and best practice regarding FL-LRIC cost modelling'* (the "PIB") published in November 2000 by the Independent Regulators Group (IRG) addressed a predominantly fixed network telecoms model and does not appear to take account of mobile networks and changing market conditions. We therefore welcome the ERG's intent to review the appropriateness of the earlier guidance but feel that a much wider review of the application of cost orientation is required than simply the earlier guidance on FR-LRIC.

GSME believes that it is necessary to start from the basis that we are now in a new regulatory environment post 25 July 2003 and that superficially reviewing previous models and then carrying them into the new regulatory environment is incorrect. The application of cost orientation and its possible unintended effects in competitive markets such as mobile needs to be considered, before going into a detailed examination of one specific approach, like LRIC. The principles of implementation and best practice that the ERG is seeking comment on, arose as a result of the EC regulatory recommendation involved in the previous regulatory environment. This recommended FL-LRIC for the assessment of cost oriented interconnection tariffs for terminating access. It is not clear to GSME why this model should simply be rolled over into the new regulatory environment.

GSME believes that the new regulatory framework is based on a new model (less intervention, more application of competition law) and new principles (adequate measures, proportionality, limited to the failure of the market detected, etc.). With this new approach price regulation and cost orientation are not the only, or obviously the best remedy for problems detected in a market. Price regulation is the most interventionist form of regulation and inhibits the efficiency of markets by establishing conditions that are in fact unresponsive to market developments ie by creating fixed prices.

The whole topic of cost orientation is extremely complex and even if FL-LRIC models were to be used to develop theoretical costs it is for example not even clear whether top down or bottom up approaches deliver appropriate results in practice. The use of complex models in the absence of any meaningful agreement on common principles

[1] GSM Europe is the European interest group of the GSM Association, the premier global body behind the world's leading wireless communications standard. GSM Europe represents around 143 operators in 50 countries/areas in Europe who serve around 380 million subscribers.

GSM Europe, 6-8 Old Bond Street, London W1S 4HP, UK
Tel: +44 207 518 0548, Fax: +44 207 518 0531, E-mail: imauro@gsm.org

would lead to distortions across Member States. Regulators need to undertake significant amounts of work before adopting any specific models.

LRIC models arose out of the need to produce a fair harmonised costing methodology that would be used when cost orientation appeared appropriate to solve competition problems. This has been most commonly applied where competition depended on access to dominant, and usually ex monopolist, fixed network operators. LRIC was applied to essentially static market environments to facilitate change to the market structure, ie new entrants. The use of the term "the incumbent" in the PIB only serves to emphasise this point. Competition has developed in a number of markets and especially in the mobile market where in all Member States there are a number of competing networks that do not have the benefit of a stable historical base of largely depreciated assets, as was the case for fixed incumbents. In fact the mobile industry is in the process of investing in its third major technology rollout, for 3G, driven in part by government policies not market demand. It is against this contrasting background that any revision of the principles surrounding LIRIC modelling should be made.

The PIB sets out principles for developing forward looking long run incremental cost (FL-LRIC) models, for *'the assessment of cost oriented interconnection tariffs'*. GSME accepts that under the new framework if the appropriate processes are followed a mobile operator may be found to have SMP but this does not automatically lead to cost orientation. GSME acknowledge that NRAs are also increasingly regulating tariffs on the basis of cost. If NRAs are to regulate mobile interconnection tariffs on the basis of cost, a proper understanding of the costs of mobile networks is essential. A failure to reflect properly the true costs of running a network when setting regulated prices risks harming operators, the competitive process, incentives for investment and, ultimately, customers. Clearly it is inappropriate for NRAs to regulate prices without a proper understanding of costs, and previous approaches to price regulation such as simple benchmarking do not adequately take account of different conditions in member states and between operators.

Cost modelling is a very complicated process and this initial consultation only raises some general questions. Our response therefore only makes a number of general points and does not involve a detailed discussion of cost modelling which we would expect to take place at a subsequent consultation(s). In particular GSME do not believe that adequate consideration has been given to Ramsey pricing and it is not good enough to simply say that it is difficult use when any costing methodology if rigorously applied (including FL-LRIC) is complex and difficult.

General points:

- Mobile networks provide coverage and capacity. Coverage is the ability to make a single call from any point of the network. The cost of coverage is unrelated to traffic volumes or customer numbers and so introduces a major cost driver that is not present in fixed markets. Fixed network cost models do not normally reflect this.

- The high degree of end to end competition in mobile markets compared with the typical fixed incumbent has a number of direct consequences on any cost modelling.

GSM Europe, 6-8 Old Bond Street, London W1S 4HP, UK
Tel: +44 207 518 0548, Fax: +44 207 518 0531, E-mail: imauro@gsm.org

- NRAs do not need to verify the reasonableness of costs that are incurred in a competitive market in the same that they did for incumbent fixed operators that may have been inefficient monopolists.

- Operators often compete with each other in different Member States. To avoid distorting competition it is important that NRAs adopt a common approach to modelling network costs.

- A particular concern for mobile operators is the way that stranded assets are treated for modelling purposes. In the more competitive and dynamic mobile market there is a danger that changes in technology and services will lead to obsolete assets that LRIC models do not adequately take account of and do not enable acceptable returns to be made.

- To achieve a consistent approach it is important that having agreed a common set of principles, the NRAs apply those principles. LRIC models of networks have not always followed the best principles established in the PIB. For example, Oftel's 'LRIC' model of a mobile network is in fact a fully allocated cost (FAC) model that allocates the stand alone cost of the required capacity to the various services.

GSM Europe believes that the ERG should consider the fundamental principles surrounding cost orientation in the light of the new Regulatory Framework and not simply take a specific methodology such as FL-LRIC, devised for different circumstances than those that are currently found in the mobile arena. We do not believe that adequate arguments have been put forward to dismiss Ramsey pricing in favour of the suggested LRIC approach in the way that the PIB (and some regulators) appear to. Ramsey pricing is acknowledged to better address some markets and it is not obvious that the difficulties with Ramsey pricing are in any way more intractable than those with FL-LRIC when the appropriate rigour is applied.

We suggest that that the ERG and its members should work with the mobile industry to gain a proper understanding of the principle costs structures involved in operating mobile networks before deciding to adopt any particular cost model.

As stated earlier GSME does not believe that FL-LRIC has been demonstrated to be the appropriate model for the application of cost orientation. However we are providing some more specific comments on the PIB to illustrate the issues that any cost modelling raises.

1. Scorched node v. scorched earth

The PIB recommended a 'modified scorched node' approach, whereby the base point for modelling the costs of a network is the existing network topology, but this is revised to remove inefficiencies. [Principle I.]

A 'scorched node' approach should take into account the forward looking principle. Some assets that might look unnecessary or inefficient in the short run may have been deployed to minimise long run costs. For example, mobile networks are currently deploying 3G infrastructure, whilst some 2G assets will be fully depreciated within a few years. One consequence of this is that the future network topography is likely to be very different to the current network topography.

GSM Europe, 6-8 Old Bond Street, London W1S 4HP, UK
Tel: +44 207 518 0548, Fax: +44 207 518 0531, E-mail: imauro@gsm.org

As noted under item 3 below, it is inappropriate for NRAs to disallow costs that are incurred by businesses in competitive markets. Therefore, NRAs should not seek to remove costs that mobile operators have incurred by characterising them as 'inefficient' without a proper understanding of why the costs have arisen.

2. Common costs

GSME agrees with the PIB that NRAs need to take account of the recovery of common costs. [Principles VI and VII.] However, the PIB produces no guidance on how this should be done, other than to say that Ramsey Prices are theoretically correct but too difficult in practice. It is not satisfactory to say that Ramsey pricing is too difficult because a properly constructed LRIC model is also difficult to construct.

3. Long run and forward looking

It is important that the implementation of any LRIC based regulated charges should send economic signals that promote efficient forward looking investment decisions.

The PIB argues that NRAs should exclude costs *'that are not relevant for regulatory purposes'*.   [Principle XIII.] When an NRA chooses to ignore costs that an operator has incurred, it is effectively substituting its judgement on what costs the business needs to incur over that of the operator's management. This may have been appropriate in fixed telephony markets where there were concerns that the incumbent operator was inefficient. However, in the case of mobile operators, the NRA will be substituting its judgement over that of management operating in competitive markets. This would not be appropriate. As a general principle, NRAs should not disallow costs that are incurred in a competitive market because the presumption should be that these are efficiently incurred.

4. Depreciation

Whilst acknowledging the theoretical superiority of economic depreciation, the PIB acknowledges that simpler approaches *'are acceptable and may be preferred'*. [Principle XV.] This leaves considerable scope for NRAs to adopt different depreciation methods, which is inappropriate given that mobile businesses often compete with each other in more than one European market.

GSM Europe, 6-8 Old Bond Street, London W1S 4HP, UK
Tel: +44 207 518 0548, Fax: +44 207 518 0531, E-mail: imauro@gsm.org

5. Reasonable rate of return

The PIB recommends the use of the weighted average cost of capital (WACC) but provides no guidance on how this should be calculated. [Principle XVI.] . It is for example important to take into account investment incentives that address the accelerating investment lifecycle we are now seeing in the mobile industry. If the ERG wants to develop more specific guidance on the determination of the appropriate cost of capital, this should form a separate set of guidance.

For further information, you can contact Isabelle Mauro, Director GSM Europe, imauro@gsm.org, +44 207 518 0548.

GSME, London 4th September 2003

GSM Europe, 6-8 Old Bond Street, London W1S 4HP, UK
Tel: +44 207 518 0548, Fax: +44 207 518 0531, E-mail: imauro@gsm.org