HSBC Global Research

Dutch Telecoms

ACM publishes draft access market decision

EQUITIES
DIVERSIFIED TELECOMMUNICATIONS

Netherlands

- ACM sees "risk of collective dominance" in the Netherlands
- Aims to introduce obligation of a wholesale cable access offer
- Worst-case scenario of cost orientation is avoided

The good news first: The Dutch regulator, the ACM, has published its draft decision on the local access market, introducing an obligation on the cable operator Vodafone-Ziggo to wholesale its network. While we regard this intervention as unjustified, the most material piece of news so far as the KPN investment case is concerned (KPN NA, EUR2.64, Buy) is that the ACM has not insisted on cost orientation. Instead, it has decided that Vodafone-Ziggo (as well as KPN) should have the flexibility to negotiate terms with resellers (provided such arrangements are non-discriminatory).

But, but, but: However, while cost-orientation may have been avoided, there are many other aspects of the proposed regulation that will raise difficult questions. (i) The ACM accepts that the Dutch market now has two market participants (i.e., KPN and Vodafone-Ziggo) of broadly comparable size and capability. The regulator therefore concedes that neither have, individually, Significant Market Power (SMP) status. Within the traditional framework, this lack of SMP would tend to support the case for the removal of *ex ante* regulation. By contrast, the ACM is trying with its draft decision to introduce further regulation on the grounds that there is a "*risk* of collective dominance" [our emphasis]. This is an unconventional approach that will need to be convincingly evidenced. (ii) According to the ACM, access to copper, fibre and cable networks are now part of a single wholesale market. This is also something of a departure from standard EU practice, which has tended to separate broadband and super-fast (or faster) broadband markets. (iii) As a counter-proposal, KPN is extending its existing voluntary wholesale agreement with resellers to its FTTH network, and for a period of seven years. According to the EC's relevant market recommendation, when a retail market is deemed competitive (as would seem merited here given the presence of two network operators plus resellers whose access to network is guaranteed by contract), then wholesale regulation is rendered superfluous.

Over to the EC: Stakeholders have six weeks to submit their views. The ACM then has two weeks to process these comments before notifying its decision to DG CONNECT at the European Commission (EC). The EC has veto rights over market definitions and findings of SMP. The ACM hopes its decision will come into force in the summer of 2018.

One significant overhang removed for KPN: We believe the ACM's proposal to introduce regulation based on the concept of "risk of collective SMP" will face serious challenges, potentially culminating in court. In any case, though, the absence of cost-oriented cable access regulation removes a significant downside risk for the Dutch market over the next three years. We have a Buy on KPN, target price EUR3.70.

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Regulation forever?

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ACM publishes draft access market decision

The good news first: no cost-oriented wholesale cable access in the ACM draft

The Dutch regulator, the ACM, published on 27 February its draft decision on the regulation of the local access market, in which it introduces an obligation on the cable operator Vodafone-Ziggo to wholesale its cable network. While we regard this intervention as unjustified, arguably the most material piece of news so far as the KPN investment case is concerned is that the ACM has not insisted on cost orientation. Instead, the ACM is to give both KPN and Vodafone-Ziggo the freedom to negotiate access conditions with resellers, provided that the terms are non-discriminatory (with a fall-back option giving the ACM the ability to set tariff caps in a scenario where commercial agreement cannot be reached).

"Risk of collective SMP" concept will require hard evidence

While cost-orientated cable access may have been avoided, the proposed regulation nevertheless raises many important questions:

(i) The ACM is of the view that, following the creation of Vodafone-Ziggo, the Dutch market now has two market participants (i.e., KPN and Vodafone-Ziggo) that are broadly comparable in size and capability. The ACM therefore believes that neither has, individually, significant market power (SMP) status.

It might reasonably be supposed that this lack of SMP status in turn implied that the regulator had actually succeeded in promoting and sustaining a competitive market, and that deregulation was therefore now in order. Indeed, the EC's own relevant market recommendation states that NRAs should not regulate a wholesale market where the associated retail market is adequately competitive (something that, in this instance, should be firmly established thanks to the presence of a pair of infrastructure competitors plus resellers that are able to rely upon the contractually guaranteed use of KPN's access network). Yet the ACM is of the view that, despite the fact that competition should be on a firmer foundation thanks to the presence of long-term contracts with resellers, regulation should nevertheless be extended – as opposed to trimmed back.

Note also that the ACM refers to the "risk of collective SMP" but stops short of stating that KPN and Vodafone-Ziggo actually have collective SMP. Instead, the ACM argues that "KPN and Vodafone-Ziggo have the incentive and the opportunity to collude tacitly. This tacit collusion will be aimed at refusing wholesale access to alternative operators". This seems to be at odds with the reality of the Dutch market, where resellers have already been able to agree wholesale access on commercial terms to KPN's VULA (virtual unbundled access) product. Given this situation, we therefore think it likely that the merits of regulatory intervention on the grounds of a "risk of collective dominance" are likely to face legal scrutiny, even were the EC to give its approval to the ACM's approach.

(ii) According to the ACM, copper, fibre and cable networks all now form a single wholesale market. This departs from the established practice in the EU, whereby markets for conventional broadband and super-fast (or faster) broadband have been held to be separate (thus sundering the market for unbundled local loops from that for wholesale fibre services, which have generally been subject to much lighter-touch regulation).

Moreover, the ACM intends to prevent KPN and Vodafone-Ziggo from requesting regulated access to each other's networks "unless that access does not have the effect of impeding competition". This could be a particular concern for Vodafone, given its focus on reaching co-investment agreements with peers in other markets (e.g., in Portugal, where it has reached an agreement with NOS).

(iii) KPN's counter proposal underlines the case for a withdrawal of regulation. The incumbent's proposals (also released on 27 February) build on the voluntary wholesale agreements with service providers that have been in place since 2015, and (indeed) extend KPN's offer on VULA to its FTTH network as well. This commitment will be for a period of seven years (i.e., considerably longer than the market review period of three years).

Timing and support from the EC
Stakeholders have six weeks (starting on 27 February) to submit their opinions. The ACM will then have two weeks to process the comments received before notifying its draft decision to the EC's DG CONNECT. The EC has a right of veto over matters of market definition and findings of SMP (see our reports, *Regulators and regulated gather in Brussels*, 19 February 2018, and *Fearful symmetry – EU regulation update*, 4 October 2017).

The ACM is aiming for its decision to come into force in the summer of 2018. However, even were the EC to decide to back the ACM's proposal, the operators involved are likely to consider legal redress. Such action would likely focus on what we consider to be the most contentious aspect of the ACM's line of reasoning – the argument that intervention can be justified by the *risk* of collective SMP.

It is worth bearing in mind that the Dutch telecoms regulator (whether in its current incarnation as the ACM, or in the form of its predecessor, OPTA) has investigated on several occasions the scope to extend regulation to encompass cable, but generally without success. In the previous local access market review, the ACM withdrew its initial proposals after the EC expressed its serious doubts.

Much clearly hinges on the review to be conducted by the European Commission. We would anticipate that the EC will pay close attention to the robustness of the analysis indicating the presence of a risk of collective SMP, but we would also expect the Commission to weigh carefully the broader implications that regulating cable would bring. The outcome of this debate will have extremely important ramifications in terms of the signals sent to investors.

If the EC approves the ACM's approach, investors in the sector will likely conclude that those building competitive access infrastructure will ultimately be rewarded only by becoming subject to the same wholesale regulation as is customarily imposed on incumbents. This will substantially chill the incentive to invest in competitive infrastructure anywhere within the EU (and not merely within the Netherlands). The case is therefore of tremendous importance in terms of the precedent it might set to discourage network investment throughout Europe.

A parallel topic is the issue of tight oligopoly, which is one of the most contentious aspects of the current negotiation of the new EU telecoms regulatory framework, the EECC (European Electronic Communications Code). To its credit, the Commission has vigorously put the case against tight oligopoly measures, and we believe that a decisive factor in its motivation to do so has been its concern about the considerable damage that would otherwise be done to investment incentives.

This might suggest that the EC will require very clear logic and robust evidence if it is to be convinced by the ACM. After all, conditions in the Netherlands (with two, near-ubiquitous infrastructure competitors) look considerably in advance of those seen in most European countries (on average, European cable coverage stands at little over 50%). If even the Dutch market requires more rather than less regulation, then the operators will likely infer that – far from Europe progressively charting a course towards eventual deregulation – the sector is liable to be regulated forever.

On the other hand, though, given that the 'trilogue' negotiations between the EC, the European Parliament and the European Council are at a crucial stage, the Commission might want to demonstrate that it has an open mind on collective dominance cases brought within the *current* rules framework (in the hope of proving that there is no need for the introduction of further measures on tight oligopoly in the EECC).

It is consequently very difficult to be confident on the outcome of the EC's review of the ACM's conclusions. Moreover, even if these proposals were to receive DG CONNECT's approval, court action would then look likely to ensue. It could therefore be a long time before the matter is definitively resolved. Ironically, though, the near term implications for KPN should be simpler.

One significant overhang removed for KPN (Buy, target price EUR3.70)

Turning aside from the broader sectoral implications right across the continent, and focusing instead specifically on KPN, we would highlight that the key fact is simply the absence (at least for the present 3-year market review period) of cost orientation. This should remove a significant downside risk for KPN, on which we have a Buy rating with a target price of EUR3.70.

		Valuation	Risks
KPN **KPN AS** **Buy**	Current price: **EUR2.64** Target price: **EUR3.70** Up/downside: **40%**	We use a DCF methodology to derive our valuation for the domestic business of KPN. We assume a risk-free rate of 2.5%, a market risk premium of 6.0%, beta of 1.1 and terminal growth rate of 1.0% (all unchanged). We value the 8.6% Telefonica Deutschland stake at the current trading price. The negative impact of reduced revenue and EBITDA estimates is offset by combination of reduced capex estimates and rolling forward of our valuation to Feb-18. Our target price is EUR3.70 and it implies 40% upside. We rate KPN Buy.	Downside risks include: (1) A pricing environment in the Netherlands being disrupted which could lead operators to switch from the current focus on up-selling/cross selling towards market shares gains; (2) A lower-than-guided dividend from Telefonica Deutschland (TD), in which KPN owns 8.6%. KPN has so far been passing through the dividend received from TD to its shareholders; and (3) changes in fixed-line wholesale regulation for KPN and/or cable.

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Priced as of 26 February 2018
Source: HSBC estimates

Disclosure appendix

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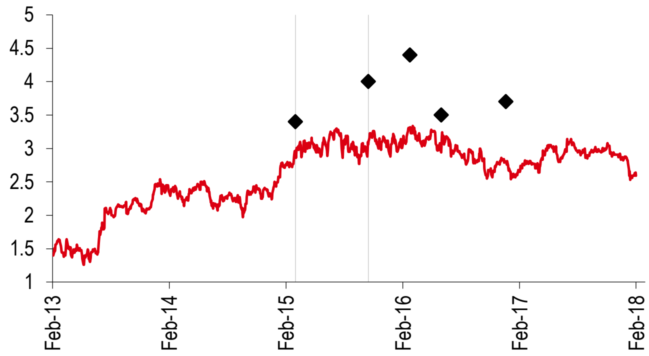
Share price and rating changes for long-term investment opportunities

KPN (KPN.AS) share price performance EUR Vs HSBC rating history



Source: HSBC

Rating & target price history

From	To	Date	Analyst
Neutral	Hold	29 Mar 2015	Luigi Minerva
Hold	Buy	12 Nov 2015	Luigi Minerva
Target price	**Value**	**Date**	**Analyst**
Price 1	3.40	29 Mar 2015	Luigi Minerva
Price 2	4.00	12 Nov 2015	Luigi Minerva
Price 3	4.40	21 Mar 2016	Luigi Minerva
Price 4	3.50	27 Jun 2016	Luigi Minerva
Price 5	3.70	16 Jan 2017	Luigi Minerva

Source: HSBC

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Source: HSBC

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