ERG Common Position on Remedies

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Contents

Introduction

The ERG document on remedies

- Common Position by ERG prepared in cooperation with the European Commission Services (DG Competition and DG Information Society)
- First published in April 2004
- Revision in 2005/2006
- Deals with appropriate (ex ante) remedies for SMP operators
- Purpose: ensuring a consistent application of the new regulatory framework

- Recently, more detailed ERG Common Positions have been published for
  - ULL
  - Wholesale Broadband Access
  - (s. http://www.erg.eu.int/documents/docs/index_en.htm)

The “Old” Regulatory Framework

- Four predefined markets
  - Fixed
  - Mobile
  - Leased lines
  - Interconnection
- 25% market share threshold
- If operator had share >25% -> predefined set of remedies

➢ No possibilities to tailor remedies to specific situations

The "New" Regulatory Framework

- Step 1: Market definition
  - Define markets according to competition law principles based on the EC's recommendation
  - Markets susceptible to ex ante regulation have to fulfil 3 criteria:
    - High and non-transitory entry barriers;
    - Market does not tend towards effective competition
    - Competition law alone is not sufficient
- Step 2: Market analysis
  - Assess degree of competition according to SMP criteria
  - Is there an SMP position?
  - Which competition problems do exist?
- Step 3: Remedies
  - In case of SMP position: impose appropriate remedies to address identified competition problems

Remedies available

Remedies in the Directives

- Remedies are set out in the Access Directive and the Universal Service Directive
- Remedies of the Access Directive:
  - Obligation of transparency (Art 9)
  - Obligation of non-discrimination (Art 10)
  - Obligation of accounting separation (Art 11)
  - Obligation of access (Art 12)
  - Price control and cost accounting obligations (Art 13)
  - Other obligations in exceptional circumstances (Art 8 (3))
- Remedies of the Universal Service Directive
  - Regulatory controls on retail services (Art 17)
  - Regulatory controls on the minimum set of leased lines (Art 18)
  - Carrier selection and carrier pre-selection (Art 19)

Access (Art 12 Access Directive)

- NRAs may oblige operators to meet reasonable requests for access to and use of specific network facilities
- NRAs may attach conditions covering fairness, reasonableness and timeliness
- Is likely to be accompanied by
  - transparency (reference offer) and
  - non-discrimination (in particular if SMP-operator is vertically integrated)
- It may also be necessary to set the level of access charges

Non-discrimination (Art 10 Access Directive)

- "Apply equivalent conditions in equivalent circumstances"
- Relates to
  - several trading partners and to
  - internal and external provision
- May also be backed by other remedies, in particular transparency

Accounting separation (Art 11 Access Directive)

- May be used for specified activities related to interconnection and/or access in order to determine a cost-based price
- May support non-discrimination with respect to price by identifying wholesale costs and, possibly, cross-subsidies
- NRAs may specify format and accounting methodology

Price control and cost accounting (Art 13 Access Directive)

- NRAs may impose obligations with regard to the access price if there is the danger of
  - excessive prices or
  - a price squeeze
- NRAs have to
  - take into account investments and
  - allow a reasonable return on adequate capital employed
  - taking into account the risks involved.
- Pricing methodology shall promote efficiency
- Cost-orientation: Burden of proof is with the operator
- NRAs may use accounting methods independent of those used by the undertaking

Transparency (Art 9 Access Directive)

- May be used in relation to interconnection and/or access requiring operators to make public information such as
  - Accounting information
  - Technical specifications
  - Network characteristics
  - Terms and conditions for supply and use including prices
- NRAs may require SMP operators to publish a reference offer which
  - contains terms and conditions including prices
  - is sufficiently unbundled
- NRAs may
  - specify the information to be made available
  - impose changes to reference offers to give effect to obligations imposed
- Transparency will usually be an accompanying obligation, in particular to access and non-discrimination.

Retail obligations

- Regulatory controls on retail services can only be imposed where wholesale regulation is insufficient(!)
- Art 17 Universal Service Directive contains a non-exhaustive list:
  - Obligation not to charge excessive prices
  - Obligation not to inhibit entry or restrict competition by setting predatory prices
  - Obligation not to unduly discriminate
  - Obligation not to unreasonably bundle services
- In case of price control NRA may specify format and accounting methodology.
- Leased lines and carrier selection/pre-selection
  - Obligations related to particular markets of the Recommendation
  - Apply “automatically” if SMP is found in those markets

Principles for choosing appropriate remedies

The four principles

- Principle 1: NRAs should produce reasoned decisions in line with their obligations under the Directives
- Principle 2: Protecting consumers where replication is not considered feasible
- Principle 3: Supporting feasible infrastructure investment
- Principle 4: Remedies should be designed to be incentive compatible

Principle 1: Reasoned Decisions

- NRAs should demonstrate that their decisions are in line with the goals as set out in the directives
- Decisions should be transparent and well argued
- Remedies need to be proportional, i.e., appropriate, necessary and the least onerous to achieve the objectives
- Where possible, alternative remedies should be considered
  - Regulatory options assessment based on qualitative analysis

Principle 2: Protecting consumers where replication is not considered feasible

- Conclusion from market analysis: entry barriers are high and structural, competition is unlikely to emerge
- NRAs need to ensure that market power is not exploited
  - Ensure that access to wholesale inputs is available to promote downstream competition;
  - Ensure that incumbent does not distort downstream competition (e.g. by margin squeeze)
  - Prevent excessive pricing of inputs but also
  - ensure sufficient return on investment so that maintaining and upgrading of infrastructure is not discouraged;

Principle 3: Supporting feasible infrastructure investment

- Conclusion from market analysis: entry barriers are high but in the long run market entry appears possible
- Infrastructure-based competition has many advantages
  - Competitive pressure over the whole value chain
  - More scope for innovation and product differentiation
- NRAs need to support market entry and roll-out of own infrastructure by alternative operators
- But: roll-out of infrastructure is costly and risky (sunk investments)
- NRAs may need to allow for step-by-step roll-out
- -> “Ladder of Investment”

Principle 3: Supporting feasible infrastructure investment (cont.)

- Ladder of Investment
  - Several access products in vertically related markets which are priced consistently
  - E.g. Broadband: Resale, bitstream access, local loop unbundling
  - Alternative operators shall have incentives to move "up" the ladder if replication is feasible. NRAs may set dynamic incentives.
  - But several access products may also be needed at the same time (complementary)
  - NRAs have to ensure that migration to the next level is not inhibited by SMP operator
  - Access pricing may become very complex
- Conclusion: Infrastructure- and service-competition are not counterparts but, in the course of time, complements

Principle 4: Incentive compatible remedies

- SMP operators have incentives to frustrate competition and circumvent regulation.
- NRAs should design remedies such that the pay-off from compliance is larger than the pay-off from non-compliance.
- Examples
  - Set financial penalties so that the regulated firm will comply voluntarily
  - SMP operator is only allowed to launch a new retail product if an equivalent wholesale product is made available before

Matching of competition problems and remedies

Important issues

- ERG document identifies several “standard competition problems”
- ERG document suggests remedies for all of these competition problems
  - When does the SMP undertaking have an incentive for a certain behaviour?
  - Which remedies are effective?
  - Which remedies are proportionate in light of the principles?
- This presentation focuses only on the most important issues:
  - Vertical leveraging
  - Mobile Termination

Vertical leveraging

- Incentives
  - Vertically integrated SMP operator may have incentive to foreclose retail market
  - E.g. in case of access obligation with cost oriented prices:
    - SMP operator can increase profits by driving competitors out of the retail market and raising retail prices
  - Or: if retail competitors may integrate backwards into the SMP-market
- Ensuring access
  - Ensure access to non-replicable input in order to promote downstream competition
  - Access obligation (Art 12 AD) most suitable
  - Sometimes, non-discrimination (Art 10 AD) + transparency (Art 9 AD) may suffice
  - If danger of excessive pricing or margin squeeze -> price regulation

Vertical leveraging (cont.)

- Setting the access price
  - Obligation of price control and cost accounting (Art 13 AD) backed by accounting separation (Art 11 AD)
  - Sometimes non-discrimination (Art 10) and accounting separation may suffice
  - Main approaches to set price:
    - Cost orientation
      - Incremental costs (LRIC): price of increment; usually forward-looking
      - Fully distributed costs (FDC)
      - (see ERG Common Position on Accounting Separation and Cost Accounting)
    - Retail-minus: Wholesale price = retail price minus avoided (retail) costs
      - Downstream entry is possible (no margin squeeze) but
      - wholesale price may be above costs
      - -> only to be used if problem of excessive prices is small
    - Benchmarking: Only if cost orientation and cost accounting is disproportionate or appropriate cost models do not (yet) exist

Vertical leveraging (cont.)

- Investment incentives
  - NRAs can influence investment incentives of SMP undertaking and entrant by
    - design of the access product (level of network hierarchy, number of access products, change over time)
    - level of the access price (level in relation to costs, change over time)
  - Principles:
    - Replication of incumbent‘s infrastructure where efficient
      - ➢Ladder of investment
    - sufficient investment incentives for the SMP undertaking

Vertical leveraging (cont.)

- Non-discrimination issues
  - Non-discrimination should create “level playing field” between incumbent and entrant
  - Obligation should be specified in a suitable manner
    - Uncertainty may benefit the SMP operator
    - E.g. equivalence of inputs: competitor has to be treated the same way as the retail arm of the SMP operator
  - Sometimes, complementary measures may be necessary
    - Internal reference offer setting out the terms on which the SMP operator makes services available to itself
    - Service level agreements with compensation payments in case of failure
    - SMP operator to publish key performance indicators such as provisioning times, repair times, etc.
    - Prohibition of unreasonable conditions to supply
      - Conditions may sound non-discriminatory but are easier fulfilled by the retail arm of the SMP operator
    - Setting conditions of migration

Mobile termination

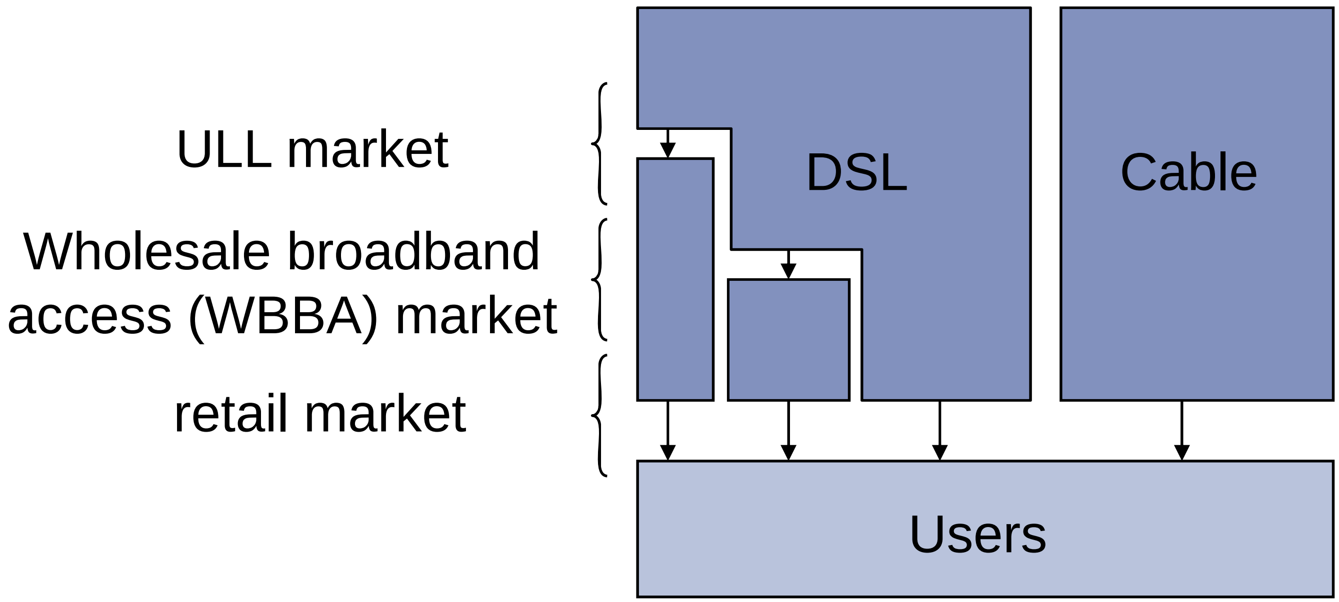
- Termination: Individual firm monopoly markets under CPP
- Competition Problem: Excessive prices for F2M termination accompanied with cross subsidies to mobile retail
- Result: Distorted pricing structure / allocative inefficiencies (even if profits are competed away)
- Considered Remedy: Price control (Art 13 AD), possibly accompanied by accounting separation (Art 11 AD)
- NRAs to take into account effects on retail markets (external effects, disruptive regulation...)

Mobile termination (cont.)

- Smaller operators:
  - When imposing remedies NRAs may balance short run „inefficiencies“ (higher rates) vs. long-run advantages to competition
  - How should termination rates be set?
    - Cost oriented prices might produce no sensible results
    - Competitive level (level of most efficient operator) may not allow the entrant to enter the market
    - NRAs may consider to impose a “glide path” termination rate approaching the competitive level over time
    - Critical: duration of „glide path“ (as inefficiencies could be supported)

Case study: Broadband internet markets in Austria

Broadband markets (simplified)



Analysis of WBBA market 2005

- Market includes DSL, Cable, Fibre, WLL/W-LAN; market is national
- Telekom Austria SMP
  - ~50% market share, increasing
  - High barriers to entry (economies of scale and sunk costs)
  - Telekom Austria only operator with own infrastructure for ~1/3 of all households
- Potential competition problems:

(i) Erection of barriers to entry by denial of access

- ➢ Without bitstream, market entry into the wholesale broadband access market by unbundling is impeded ("ladder of investment")

(ii) Leveraging of market power to the retail level by denial of access

- ➢ Increased barriers to entry at the retail level
- ➢ Unbundling ISPs cannot act nationally -> cost disadvantages
- ➢ Erection of barriers to entry at the wholesale level -> less competitive pressure from ULL operators

(iii) Exploitative abuses (pricing)

Analysis of ULL market

- Telekom Austria SMP
  - ~100% market share
  - High barriers to entry (economies of scale and sunk costs)
- Potential competition problems:

  (i) Denial of access to leverage market power to downstream markets

  (ii) Excessive pricing to exploit consumers or effect a margin squeeze

  (iii) Non-price discrimination
    - Delaying tactics
    - Quality
    - Design of product (technical standards)

Remedies

- Access-obligation
  - WBBA: Access to bitstream-products (including naked DSL)
  - ULL: Obligation to offer unbundled local loops
- Price control
  - Retail-minus for WBBA as problem of excessive pricing is not considered to be large
  - Cost oriented prices for ULL (“hardcore” bottleneck)
  - ➢ 2 margin squeeze tests
    - Retail – WBBA
    - WBBA – ULL
- Non-discrimination
- Reference offer
  - WBBA: Including terms of migration between different wholesale products
- Accounting separation

Retail-minus

- When is retail-minus applied?
  - If excessive pricing is not a major problem
- Advantages
  - No margin-squeeze for alternative operators possible (if calculated correctly)
  - Correct investment incentives for downstream entry
  - Gives more freedom to SMP-operator (less intrusive)
  - Reduced incentive for SMP-operator to disadvantage competitors
  - May be easier to calculate (but not necessarily)
- Disadvantages
  - Excessive prices retail feed into excessive prices wholesale
  - If wholesale prices are excessive => wrong investment incentives for upstream entry

Retail-minus - Decisions to take

- Benchmark: incumbent or entrant?
  - Desirable benchmark: “efficient operator” (retail)
    - Incumbent: might benefit more from economies of scale but might be inefficient (x-inefficiencies) – data more readily available
    - Entrant: less economies of scale but might be more efficient on retail level – usually no good data available
    - RTR: Benchmark is incumbent
      - Is reasonably efficient
      - ISPs seem to be able to cope with economies of scale
      - Data available

Retail-minus - Decisions to take (cont.)

- For each product or for a basket?
  - For each product: less flexible, but more certainty for alternative operators
  - For basket: more freedom for incumbent
  - RTR: 3 baskets: ADSL residential, ADSL business, SDSL business, but additional obligations:
    - Prices of neighbour-products must be consistent
    - Benchmark for new bistream product(s) is average “old” margin
  - E.g. Ireland: Product by product
- Timeframe
  - RTR: Period of one year as market has a seasonality of one year (Christmas promotions, etc.)

Retail-minus - How is the minus calculated

- RTR:
  - Marketing and sales
  - Billing and bad debt
  - Product development and product management
  - Customer service and call center
  - Costs of internet connectivity
  - Costs of additional services such as web space, e-mail addresses, etc.
  - Other retail common costs

  Additional costs of SMP-operator (to be added)
  - Wholesale billing
  - Administrative costs
  - Additional investments due to external provision