Explanatory Memorandum to ERG (03) 30rev1

This document supporting the revised version of the Remedies paper (ERG (03) 30rev1) (the "Document") explains the changes made regarding the main issues addressed in contributions to the consultation procedure. It is not an exhaustive list of all contributions, but deals with the points that have been brought up most frequently. It offers the reasons why certain points have been taken on board and why others have not, thus providing transparency and the necessary feedback to contributors. It highlights in which way the results of the consultation have been taken into account and eventually had an impact on the final product.

Status, structure and outline of the Remedies document

The final status of the Document is an ERG Common Position on the approach to the application of remedies in the new regulatory framework (NRF). It will be adjusted periodically in the light of practical experience. In particular, further revisions of complex topics such as "emerging markets", "ladder of infrastructure investment" and "replicable/non-replicable infrastructure" may be developed at a later time.

The structure of the original text was kept as it follows the logic of the NRA's decision making process when choosing a remedy. However, in a new Chapter 1[1] "**Purpose and Context**" the general background and the framework of the analysis are spelled out to give better orientation. Where possible the document was made more readable. However, given that the purpose of the document is to provide guidance to NRAs so that they can implement the framework in a consistent and transparent manner with regard to remedies, much of the detailed discussion is necessary.

An effort has been made in the new Chapter 1 to give a context in which the rest of the document can be read. It is hoped that this will enable readers to access particular sections without having to read the entire document at once. This chapter also provides a clear statement of the underlying de-regulatory objectives of the NRF as well as the overall approach.

It was criticized that the draft document that went to public consultation gave the impression of an automatism in choosing remedies, according to which the remedies under the NRF are the same as those under the old ONP regime, thus creating "overregulation". This is a concern to ERG. This perception arises, in part, from the structure of the document. As mentioned above, a new introductory chapter has been added to give the proper context. Also, the differences between the old and the new framework are now more accentuated.

In the revised version of the document, it is pointed out that the finer granularity of the NRF requires more analysis (e.g. 18 instead of 4 markets and decisions must be well reasoned) – which is especially true in the transition period when switching to the new framework – but will ultimately allow NRAs to implement tailor-made regulatory solutions targeting the lack of competition identified in a specific market,

[1] The old Ch. 1 becoming Ch. 2 in the new version and so on.

thus lessening regulatory intervention over time. While granularity adds complexity, it enables deregulation of areas previously part of an overall market (having in mind that markets cannot be narrowed down to ever smaller parts and that a balance has to be found between the size of defined markets and the resulting administrative burden) and, as such, subject to the same level of regulation irrespective of competitive differences of areas and/or products.

This should allay fears that regulation will be easily applied to markets other than those in the Commission's Recommendation. Even in these markets, once SMP has been found, the document outlines a nuanced approach to regulation where the basis of the competition problem may not endure into the medium and long term (i.e. where replication is possible). In these circumstances regulation must support the process of delivering competition over competing infrastructures and platforms. This more nuanced approach is now better reflected in the integration of what were chapters 3 and 4.

Giving NRAs the freedom to choose the most appropriate remedy instead of prescribing mechanistically a certain reaction (specific instrument) also implies that the principles provided with this document as guidance to NRAs can help them, but do not release them from undertaking their own analysis and finding the solution that fits best to the national market situation.

Therefore, it is emphasized that regulation should always be made on a case-by-case basis.

It is not assumed that each of the problems identified in Chapter 2 automatically occurs in a particular situation. Rather, Chapter 5 includes an incentive-discussion on a general level, where the incentives of an SMP operator to engage in a certain type of exclusionary or exploitative behaviour are elaborated. Of course, regulatory action will always have to be based on the particular (national) circumstances at hand, which are identified in course of a detailed market analysis but which are beyond the scope of the Document.

It is pointed out that the analysis of Chapter 5 is made on a general level, abstracting from many conditions which NRAs usually will face and will have to take into account when taking decisions about remedies. Therefore the conclusions drawn should be viewed as guidelines and in no way aim at advocating a mechanistic approach or preclude NRAs from coming to different conclusions based on a thorough market analysis and taking into account the particular circumstances at hand.

Specific issues (by order of chapters, new version)

The following main issues were either introduced or reviewed.

Chapter 1 (new version): Purpose and Context

- **Clarify the notion of "structural barriers" and remedies, which influence the market structure (e.g. access regulations)**

  The notion of "structural barriers" vs. remedies which influence the market structure is clarified by stating that NRAs can, by means of the remedies of the NRF, e.g. an access obligation, certainly address aspects of market structure, such as barriers to entry. It should be noted that these remedies – although addressing structural barriers – are behavioural by nature. The structural barriers as mentioned in the Commission's Recommendation (e.g. economies of scale and scope or sunk costs), however, are conditions which cannot be influenced by regulatory intervention. Also, the relationship between ex post control (competition law intervention) and the necessity of ex ante intervention through regulation is explained. (*Part 1.1 – Background*)

- **The assumption of the three-step process (first market definition, second market analysis with SMP designation, third the application of remedies) as the basic framework of the analysis is made more explicit**

  It is stressed that this document only focuses on the "third stage" in the process, i.e. situations where relevant markets have already been defined and SMP operators have been identified. It is clarified that the Commission itself has already applied the criteria to identify markets susceptible to ex ante regulation for the markets included in the Recommendation and hence has also investigated the sufficiency of competition law. NRAs must address these issues themselves when they notify markets that are not included in the Recommendation. (*Section 1.2.1 – Remedies in the context of the NRF*)

- **Reference should be made to the three main objectives of Art. 8 Framework Directive**

  It was criticized that the objectives of contributing to the internal market and promoting consumer interests were not taken into account. This has been taken on board, in particular, the point is made that the process of achieving a consistent approach to remedies itself serves the interest of the internal market. Further the general principles underlying the framework (mainly the linkage to competition law principles) are emphasized.

- **The relation of Chapter 4 (Principles) to the three main objectives of Article 8 of the Framework Directive should be explained**

  There is now an expanded discussion that motivates the principles outlined in Chapter 4 using the Directives and Article 8 of the Framework Directive in particular. This enables the reader to see that the principles arise organically from the Directives. It is highlighted that there is a consumer interest of service competition as a means to create choice. It is reasoned that there is no conflict between competition on the one hand and investment and innovation on the other hand. This is illustrated by Art 8(2c) Framework Directive from which follows that encouraging efficient investment in infrastructure and

innovation is a means to promote competition in the provision of networks and services. (*Section 1.2.2 – The Objectives of NRAs*).

Chapter 2 (new version): Generalization of competition problems

- **An attempt should be made to shorten the chapter and to simplify the language**

The structure and presentation of Chapter 2 has been simplified by eliminating some headlines; a few paragraphs dealing with economic concepts not strictly necessary in this context have been eliminated (see section on bundling/tying). Figure 1, which can be said to provide a summary of the Chapter, has been moved to the end of the chapter.

- **Some commentators felt that the competition problems identified are hypothetical and not based on the reality of communications markets**

The competition problems outlined in Chapter 2 are based on a stock-taking exercise performed by the IRG working groups, on the inputs received in course of the ERG consultation in June/July 2003, and on several documents dealing with competition problems and/or regulation. Most of the problems identified therefore are based on NRAs' experience and reflect communications markets reality. In addition, some problems are considered which are frequently discussed in the literature related to telecommunications markets and competition policy. As mentioned previously, it should not be taken as given that all the competition problems identified occur in all instances. The market analysis carried out by the NRA will highlight the actual competition problems in any given situation.

- **It was asked by several contributors why termination is considered as a fourth market constellation (as it could be integrated into the other cases)**

Although the problems described in relation to termination may also be subsumed under the other three constellations, due to its particularities and its practical importance it is considered as a separate case.

- **It was pointed out that there was an additional competition problem relating to the bundling of retail access and call services**

Bundling of access to the public (fixed) telephone network with a package of call minutes has been added as an example for the standard competition problem 'bundling/tying' (cf. section 2.4.2). WLR and flat rate interconnection offers are discussed as remedies for that bundle in particular. (cf. section 5.3.2).

- **Reconsider the definition of excessive pricing and of price discrimination**

It has been pointed out that the definitions used are based on economic concepts. The definition of excessive prices has been adapted as follows:

According to economic analysis, prices can be considered excessive if they allow the undertaking to sustain profits higher than it could expect to earn in a competitive market (super-normal profits). (*Point 2.3.3.2)*

Chapter 3 (new version): Remedies available

- **Some remedies under the USD are not discussed**

The discussion on leased lines and carrier selection and carrier pre-selection has been extended to deal with this point. The Document now provides an explanation of why these topics are treated separately and are not part of the discussion in the Common Position.

- **Commentators want guidance on exceptional remedies**

This point has not been taken on board. It is not possible in a general document to envisage particular exceptional circumstances that may arise. The procedure for imposing these exceptional remedies is also subject to the Commission veto power. Thus, these exceptional remedies are not remedies that NRAs can seek to agree upon in advance in line with Art 7(2) FD.

- **The remedies proposed are too general. There is a need to discuss remedies such as curbs on win-back activities, wholesale line rental, access to information systems etc.**

The remedies as outlined in Chapter 3 are the ones outlined in the Directives. A more detailed discussion on remedies and what is potentially included within the remedies available is outlined in Chapter 5. It is also important to bear in mind that the Document looks at the final stage of the process without the benefit of the information that would be obtained in a detailed market analysis.

- **Chapter 2 needs to reflect the hierarchy of remedies**

To some extent this was already reflected in the original chapter. However, to bring out this point more readily, more text (which draws from the recitals of the AD) has been added in the sections on mandating access and on price controls as these are the most onerous remedies available.

- **One firm argued against the view that Art 10(1) AD applies only to access and interconnection**

The document only deals with obligations imposed on firms with SMP, which is explicitly mentioned in Article 10(1) of the Access Directive by references to Article 8 of the same directive.

- **Some commentators asked how AD remedies can be applied to retail markets**

  A sentence in the document that went to public consultation was unintentionally misleading and the text has now been revised to reflect more properly what is in the Directives (cf. *section 3.2.6 – Retail Obligations*).

- **NRAs are not free to select the accounting model – it has to be economically justified, consistent and meaningful**

  This point was taken on board by referring to the relevant text in Art 13(2) AD.

- **Clarify the use of the terms "obligations" and "remedies". Are remedies an expression of the details of a wider obligation?**

  This is not a correct interpretation. The terms 'instruments' and 'remedies' are used as in Art 7(2) FD. In the Document this is shortened to remedies; and remedies should be understood to be identical to obligations. In order to ensure maximum effectiveness and compliance, the design of remedies must strike the correct balance between generality and specificity (cf. *section 4.2.1*).

Chapter 4 (new version): Principles to be applied by Regulators in choosing appropriate remedies

- **It was remarked upon that the principles were procedural and substantive. Parties argued that these should be separated out and they should be linked to the objectives of NRAs. Some commentators argued that not enough guidance was given on the concept of proportionality**

  These comments have been accommodated. Principles 1 and 4 have been merged as both of these relate to the need to produce reasoned decisions in line with the requirement that the remedy is based on the nature of the problem identified, proportionate and justified in relation to the objectives that NRAs have. There is an expanded discussion on what is meant by proportionality and how NRAs can demonstrate that they respect this requirement. The notion of regulatory forbearance is dealt with when considering proportionality.

- **Some commentators argued that as much focus must be on effectiveness as on proportionality**

  This is an important point and has been dealt with in the discussion of the principle that NRAs produce reasoned decisions in line with their obligations. The remedies under discussion in the Document must be based on the nature of the problem identified, proportionate and achieve the objectives of NRAs. Clearly proportionality is about choosing between alternative effective remedies.

- **The issue whether principles for imposing remedies should be taken into account alternatively or cumulatively must be clarified, and there should be a hierarchical order between the principles**

The principles have been modified to reflect the different nature. The first principle deals with what NRAs should include in their reasoned decisions in order to fulfil their obligations under the Directives. These apply generally to all remedies. The next two principles deal with two alternative situations: one where replication is considered not likely to occur and one where it is considered likely as only one of these applies in respect of any given situation. The final principle deals with building in mechanisms that give incentives to the regulated firm to comply with the remedy. This final principle also applies generally**.**

- **Some commentators called for a full cost benefit analysis. Others asked that some consideration be given to compliance costs**

The Directives do not require a full cost benefit analysis. There is a presumption that when SMP is found on a market that is susceptible to ex ante regulation, that such obligations are globally welfare improving. Proportionality requires that the wins and losses associated with different remedies be compared so that the least burdensome effective remedy can be identified. Compliance costs are included within the notion of proportionality and in the principle of incentive compatible regulation. Additionally this aspect has been dealt with in Ch. 5.

- **Some commentators asked for guidance to be given about when replication is considered economically efficient**

As made clear in the Document the notion of replicability has economic, technological and timing dimensions. It is neither fixed as between countries nor over time. It should be borne in mind that the Document is not pitched at a level where these determinations can be made. Nonetheless, in line with comments received the text was extended to include (in the consideration of whether replication was feasible) consultation with other NRAs and with industry players on the subject of replicability.

- **Much greater emphasis on innovation and Schumpeterian competition in both market definition and remedy stages of the process was requested**

These issues are important and will become increasingly so as convergence becomes more and more a reality. In so far as they relate to market definition these issues can be taken on board when the Commission comes to review the Recommendation. These issues may also be considered when the further work on emerging markets is undertaken. Within the remedies document the principle that competition over infrastructure should be promoted when replication is possible allows for the possibility that the replication can be from another platform. The document points out that in these circumstances NRAs must be aware of the impact that their decisions have on all players' investment incentives.

- **Citing recent case law with respect to the EC Merger Regulation it was argued that, analogously with merger analysis, the NRA must show that there is (a) a very real likelihood of the competition problem occurring and (b) that the NRA must spell out about how they see the anticompetitive effect coming about in a realistic manner. It is argued that the incentive to abuse is not sufficient to impose a remedy**

  Policymakers have seen fit to give NRAs the power to impose obligations once SMP is found in a market that is susceptible to ex ante regulation to remedy the competition problem assumed to exist when SMP is found in a given market. Furthermore the analogy with mergers is not appropriate. Merger control seeks to control the probable harm that may occur if a merger is cleared. In the vast majority of instances there are no substantive issues and mergers are cleared. Thus, in relation to mergers there is a presumption that most mergers do not raise competitive concerns. Regulation, however, deals with ongoing real issues in a market that is often characterised by what some commentators call "super-dominance".

- **It was stated that mobile operators are voluntarily negotiating with MVNOs and that this should continue to be left to commercial negotiation**

  The role of voluntary commercial negotiation is now recognised in the document, both as a background as to when access can be granted and in the section on incentive compatible regulation.

- **It was claimed that principle 5 goes beyond the power given by the NRF**

  The power to create incentives to comply with remedies is already envisaged in the framework. Where consistent with national law and administrative practices, imposing financial penalties for non-compliance is allowed under the powers granted under the Authorisation Directive [2002/20/EC].

- **Incentive compatibility risks double jeopardy if the NCA also imposes fines**

  The fact that a firm is subject to regulatory obligations in no way removes the general obligation to comply with Competition Law. Incentive compatible regulation is about aligning the incentives of the regulated firm with that of the regulator. This may take the form of a penalty for non-compliance with a specific obligation. If in not complying with an obligation an undertaking designated with SMP also breaches Art. 82, it will also be liable to whatever fines can be levied under Competition Law (and the prospect, in some cases, of private action for damages).

- **Some commentators asked for clarification on whether bitstream access is not a market in itself, but a remedy**

  In the Commission's Recommendation on relevant markets there is a market for wholesale broadband access. Bitstream access is the core product in this

market. Other equivalent products can be added to the market if and when other infrastructures offer facilities equivalent to bitstream services.

- **Some commentators argued that the maintenance of investment incentives in CEE states, where penetration is low, is crucial. Others argued that all Member States should be treated the same**

The particular circumstances of Member States are best taken account of at the market definition and the analysis of SMP stages of the process. It is important that NRAs in approaching remedies are guided by the Common Position. However, specific national circumstances may arise which could justify a different approach to the application of remedies in individual cases. In such cases NRAs shall set out the reasons for their approach.

- **The text on emerging markets should remain in the Document**

The section was overhauled and split into 2 parts: the first relating to the definition of emerging market was moved to section *1.2.1 – Market definition*, while the second part dealing with the problem of leveraging market power, when a new services is offered via existing infrastructure (requiring an input not easily replicable) with the risk of foreclosure of the emerging market, was removed to Ch. 5 and is now dealt with under *Case 1: Vertical leveraging*. In this case, regulatory action might be warranted to guarantee access to this input in the normal manner, in order to allow competition to develop in the emerging market.

It is also acknowledged that further work on the subject of emerging markets may be warranted.

- **In relation to emerging markets it was asked why the ERG does not trust competition law to handle potential abuses**

In general in an emerging market competition law is the appropriate tool to deal with potential abuses. However, where foreclosure by denial of access to a non-replicable input has the potential to monopolise an emerging market, *ex ante* regulation of the non-replicable necessary input market is likely to be warranted. In this way, the distinct nature of the emerging market is maintained whilst at the same time preventing foreclosure by applying regulation only on the necessary input market. The Document makes it clear that action in the emerging market at a retail level is not envisaged.

- **Emerging markets should be treated like all other markets to avoid foreclosure by the fixed incumbent**

In the particular case of a threat of foreclosure (through the use of a necessary non-replicable input) of the emerging market, there is a regulatory case for mandated access to such an input. On an emerging market it is not envisaged that other forms of foreclosure would be tackled in the same manner, unless

these forms of foreclosure would have the same effect of monopolising the emerging market at the retail level.

- **The approach to emerging markets may hamper innovation. As presented the criteria are not workable**

The Document provides some extra clarity on what is an emerging market. This will deliver greater certainty to market players and promote investment and innovation. The approach to emerging markets suggested in the document is that in general they should only be subject to general Competition Law. Only in the case where foreclosure by the use of a non-replicable necessary input is an issue regulation (of the input market) is envisaged. In most cases, such an input market is likely to be subject to regulation even before the emergence of the market.

It has been made clear in the Document that the defining characteristic of an emerging market is that NRAs cannot appropriately apply the three criteria test to determine if they have a market that is susceptible to *ex ante* regulation. The Document highlights mobile data broadband services as a potential candidate for an emerging market and draws on text in the Explanatory Memorandum to the Recommendation on relevant markets to show this is the case. Thus, the criteria for identifying what is an emerging market are, in the opinion of the ERG, workable. More work is likely to be required on when the three criteria can be applied to a market, thus removing its status as an emerging market. This is one of the topics where on-going work is planned.

- **Related to emerging markets it was requested to make sure that it is only access to non-replicable legacy infrastructure that is envisaged. It was argued that it should not be ruled out that markets within the Recommendation are emerging markets**

The Document makes the conditions clear where regulation of an upstream input market to an emerging market can be subject to *ex ante* regulation. No market in the Recommendation is emerging, as they have all passed the 3 criteria test.

- **SMP firms will have an incentive to dress up services as emerging ones. Also, concern was expressed about the need for SMP firms to configure investment so as not to drop current access seekers**

Firstly, if the new service can be shown to be in one of the markets in the Recommendation it is clearly not emerging. The character of a market as being emerging is to be clarified at the market definition stage in applying the 3 criteria. If the 3 criteria are fulfilled, the market would be a market that is susceptible to *ex ante* regulation (of course, SMP would have to be found on this market before remedies could be applied).

Firms should not be able to circumvent existing regulation by strategically re-configuring their networks. If this were to be the case, regulation would become untenable. What is under discussion here is that where firms are

making major investments to upgrade their networks they should be aware of their outstanding regulatory obligations, and where possible and feasible, make choices consistent with these obligations.

- **It was brought forward that the benchmark regulatory option should be no regulation at all**

As stated above, the starting point of the analysis is that SMP has been identified on a relevant market susceptible to ex ante regulation, in which case at least one obligation must be imposed.

- **An argument was put forward against "hindsight bias" where regulatory focus is only on successful innovations, which fail to take into account the risk of the project as seen from the day upon which it was initiated**

These issues could potentially arise when an emerging market meets the three criteria test and the main operator is designated as having SMP on this market. NRAs will of course, have to consider such issues.

Chapter 5 (new version): Application of remedies to competition problems

- **Chapter 3 (Principles) and Chapter 4 (Mapping) should be more closely linked**

The introduction of Ch. 5 now includes a section stating how the principles of Ch. 4 are taken into account. The application of Principle 1 is ensured by the approach adopted to select effective remedies. Principle 1 and 4 were merged and are dealt with in the introduction to Chapter 4 on a general level, additional considerations regarding the principle of proportionality are made in the main text where necessary. Principles 2 and 3 are in particular relevant in the case of vertical foreclosure and are discussed in the relevant sections. Principle 5 can be dealt with on this general level of analysis only to a limited extent.

- **Several issues surrounding the use of LRIC and FDC approaches as a basis for setting the access price**

Section 5.2.2.2 (setting the access price) has been redrafted. In particular, the text reflects that ascertaining the costs of specific alternatives or services provided by a vertically integrated electronic communications undertaking is a complex task that can be approached in a number of ways. A starting point could be the incurred costs of the organisation adjusted to take account of factors such as asset valuations (applying the use of current cost accounting) or efficiency assumptions (such as the exclusion of non-relevant costs). Alternatively, or in addition, business or engineering models could be constructed using different financial or operational assumptions.

Also, in this section the measures falling under Art. 13 price control measures are categorized further: cost orientation, ECPR (retail minus), benchmarking.

Further it is also mentioned that cost models may include time varying components when used e.g. to calculate dynamic access pricing rules.

Further details regarding cost allocation methods in particular will be provided with the updated Recommendation 98/322 on Accounting Separation and Cost Accounting currently under review by the IRG and the Commission's Services.

- **Some commentators stated a view that they did not see evidence of the ladder thesis. Examples should be given of where the ladder concept has been used. Nonetheless many of these commentators welcomed the notion of dynamic access pricing**

The text on the "ladder of infrastructure" makes it clear that for it to become operational is a complex task. The relative prices of the various forms of access need to be made consistent with an incentive "to climb" as does the configuration of allowable access products. It has been added that when designing dynamic access prices, potential margin squeezes must be checked.

It was pointed out that the "ladder of infrastructure" is a corresponding regulatory strategy that bridges the gap between "(short term) service competition and (long term) infrastructure competition" by enabling new entrant operators to climb up the ladder of infrastructure investment in a step-by-step way using service competition as a vehicle. This requires NRAs to fine tune regulatory measures in such a way that a set of (mandated) access products with a consistent price structure both allows new entrants to move on, but at the same time also pushes them to do so rather than remaining on the rung of the ladder they are on already. Thus the existing incentives to become more independent by investing in own infrastructure need to be reinforced by carefully designed access products accompanied by e.g. dynamic access pricing, which aim at getting the distance ("gap") between the rungs of the ladder right.

It has been added that there is empirical evidence for the 'ladder of investment' concept from the Netherlands (cf., e.g., Cave et al, 2001: 'The Relationship between Access Pricing and Infrastructure Competition') and that the concept in general is in line with NRAs' experiences. Notwithstanding this, it has to be further elaborated and reassessed as it is applied in practice.

- **In fostering infrastructure investments by dynamic access prices, NRAs should take into account macroeconomic conditions and the views of the financial industry**

A sentence has been included in *section 5.2.2.3* (incentives to invest) stating that when applying a dynamic access pricing regime, NRAs should also take into account general investment conditions.

- **Eliminate formulation that access prices could even be set below costs**

  The formulation "below costs" (*section 4.2.2.3*) has been replaced by "a level allowing for economies of scale and scope disadvantages of the entrant". It is also mentioned that switching costs may be taken into account.

- **The issue of fixed termination access and non-reciprocal termination charges for new entrants needs to be covered in more depth. The coverage should include a discussion regarding grace periods or "delayed reciprocity". The issue of "soft regulation" for fixed *and* mobile newcomers/small operators should be addressed**

  F2F considerations have been added to competition problem 5.2 (excessive pricing on termination markets). The potential problems are described in *section 2.3.4*, the remedy discussion, including considerations of delayed reciprocity and the treatment of new entrants is dealt with in *section 5.5.2*. The approach suggested for fixed sector new entrants is similar to the one, which has been suggested for mobile entrants. Also, the issue of equal treatment of larger and smaller operators is looked at in the context of sustainable competition. The issues of soft regulation will be further discussed in the course of the 2004 work program of the ERG.

- **Section 5.6 – Joint Dominance**

  This section has been deleted as it was considered not mature enough for publication in the final document. Further work on this important topic is needed and will be undertaken. The results will be included in a future version of the Common Position.