THE FUTURE OF REGULATION

AN ANALYSIS OF DEVELOPMENTS IN EU TELECOMS MARKETS AND THE IMPLICATIONS FOR THE EUROPEAN COMMISSION'S REVIEW OF RELEVANT MARKETS

EXECUTIVE SUMMARY

February 2014

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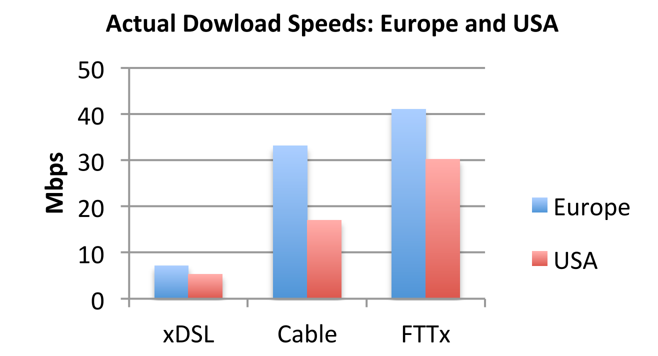
1. EXECUTIVE SUMMARY

Market Performance

The European broadband story, like that of European telecommunications, is generally one of success. Consumers have benefited materially from increasing broadband competition over the past ten years: access speeds have increased, retail prices have fallen[1], while choice has expanded and European consumers enjoy faster access speeds and lower prices than their American counterparts.



Data Source: SamKnows.com

Notwithstanding the increased competitiveness of retail markets, incumbents remain dominant at the wholesale level. The success in retail broadband markets has come about largely because access regulation has allowed entrants to gain access to economic bottlenecks owned by the incumbent. In particular, access to networks at the physical level - through local loop unbundling (LLU) - has enabled entrants to innovate and differentiate their services from the incumbents'. Had entrants been unable to gain access to economic bottlenecks on regulated terms, the incumbent would have been able to foreclose the market, such that entrants would not have been able to compete effectively and drive the consumer gains above.

There is some work to do to ensure that these competitive gains are not lost in the move to fibre access.

In particular, recent technological developments, such as vectoring, and the regulatory push for "virtual", rather than physical, unbundled access (VULA) to new fibre networks, have led to concerns that the competitive gains that have arisen from LLU could be reversed. This is because VULA and bitstream access over vectored VDSL do not allow entrants as much flexibility to set their own quality of service parameters. Instead they have to rely on the access speeds and other parameters set by the incumbent operator. It is important that SLU continues to be made available and, where possible, physical unbundled access to new fibre networks, in order to encourage infrastructure investment and innovation by alternative providers. In other words, the various rungs on

[1] This is despite increases in wholesale access prices in certain countries, for example in Italy, the effect of which has been to reduce significantly the margins earned by alternative providers.

the ladder of investment must be preserved to foster and drive competition and innovation in retail markets.

There is also work to be done to ensure that business customers are able to secure the services they require on regulated terms and are thus able to benefit fully from competitive provision and are not forgotten in the race to meet the European Commission's consumer-focused Digital Agenda targets[2].

Investment

The picture for investors and for investment in the industry in the EU is also a positive one. Over the past five years, entrants have seen Earnings before Interest and Taxation (EBIT) margins rise from an average of 8% in 2008 to 15% in 2011 before falling back to 10% in 2012. Over the same period, incumbents have seen a fall in EBIT margins from around 19% to 13% in 2012, but Deutsche Bank expects incumbents' EBIT margins to rise to 16.8% in 2014 whilst entrants' margins will increase to 11.9%. Over the same period entrants and incumbents have been able to maintain capital expenditure at between 14% and 19% of sales.

Existing regulatory framework

The European regulatory framework follows the principles of competition law and economics and applies regulation only where there is evidence of Significant Market Power (SMP) in relevant markets. In order to secure some degree of uniformity across the EU, National Regulatory Authorities (NRAs) are required to conduct *ex ante* market reviews of those markets identified in the European Commission's Recommendation on relevant markets susceptible to ex ante regulation. There are seven markets listed in the current version of the Recommendation. With one exception, these markets are all at the wholesale level.

Very few NRAs have found the complete absence of SMP in the relevant markets, indicating that there is still a general problem of SMP across all seven markets. In the limited number of cases where an NRA has found that no provider has SMP, this has been due largely to circumstances that are specific to the Member State concerned.

[2] WIK-Consult, "Business communications, economic growth and the competitive challenge", 16 January 2013.

Recommendations for the future of regulation in Europe

From our evidence-based review of the performance of the market to date we conclude that there is no case for an extensive overhaul of the current regulatory framework. On the contrary, there is every reason not to make changes to a regime that is working well. Europe is not, as is argued by some doom mongers, falling behind other areas of the world. In fact it is keeping up with and exceeding the performance of many countries.

Any unjustified withdrawal of regulation at this stage would be detrimental. Reliance on competition law alone would be insufficient and would risk harming the future development of the market, except in very specific situations and after careful consideration.

It is also our view that the ladder of investment remains a valid concept and is critical to the continued development of the market. Without entry-level wholesale access products available, for example Wholesale Line Rental and bitstream, entrants are unable to develop a base position from which to invest further in the market and to compete at a deeper level, thereby enabling them to innovate more effectively and better meet consumers' needs. New entrants often use the number of customers on bitstream in an exchange area as a key criterion when deciding whether to invest in LLU. This investment ladder must also be replicated in the fibre world to the greatest extent possible, in particular if the political objective is to create a single market in which operators can successfully enter other European markets and build a pan-European footprint.

Proposed changes to the list of relevant markets

As a general point, it is important to recognise that the conditions of competition are not uniform across the EU. There is a danger in removing markets from the list of recommended markets based on market developments which might have an uneven impact across the EU, i.e. be more prevalent in one Member State (or even in one region within a Member State) than another.

Although individual NRAs are not precluded from regulating markets which are not included on the list of recommended markets (and the European Commission expressly acknowledges this in the draft Explanatory Note accompanying its proposed revised Recommendation on Relevant Markets), the removal from the list gives a strong de-regulatory signal to NRAs. The risk is that the *de facto* outcome of removing certain markets from the list of relevant markets will be that these markets are de-regulated, potentially prematurely. At the very least, there is likely to be a degree of uncertainty as to what will happen in those EU Member States where continued regulation might in fact be warranted.

Against that background, our conclusions on the specific markets included in the existing Recommendation on Relevant Market are as follows:

Fixed Voice Access and Origination Markets (Markets 1 and 2)

We do not consider that there is any case to withdraw Markets 1 and 2 from the list of relevant markets, as proposed by the European Commission.

Incumbent operators remain dominant in the retail fixed access market in most countries and in the wholesale voice calls market. If regulation were withdrawn from these markets, incumbents would not be subject to any effective constraint on their behaviour.

There is no evidence to date to justify a finding that, at EU level, the markets for fixed access or fixed call origination are no longer characterised by high barriers to entry and tend towards effective competition. The factors cited by the European Commission in the Explanatory Memorandum to its draft revised Recommendation on Relevant Markets are not borne out by the evidence or the detailed engagements we have had with market participants in developing this report. For example, the European Commission cites the increased availability/usage of managed VoIP services. However, it fails to note that only around 61% of European households have broadband access and that, for the remaining 39% of EU households, managed VoIP services are not a substitute. Nor would competition law tools prove adequate to deal with any issues in these markets: competition law enforcement typically takes too long and is too complex to provide an effective and sufficiently timely remedy against the likely harm caused.

Wholesale line rental (WLR) remains an important remedy for both residential and business users. The continued availability of WLR would allow entrants to offer an alternative to the incumbent where LLU is uneconomic or still not available; to customers who do not have broadband; and to business customers for whom VoIP is not an effective substitute on quality, availability or cost grounds.

Although the usage of Carrier Selection (CS) and Carrier Pre-Selection (CPS) has declined, it is important that these products remain available and, as discussed later in this report, research has shown that they have acted as an important competitive constraint on fixed call prices. The continued regulation of Market 2 is also important to ensure the continued competitive provision of call origination services for value-added services (e.g. Freephone numbers).

Fixed and Mobile Voice Termination Markets (Markets 3 and 7)

There have been no market developments which justify the removal of voice call termination markets from the Recommendation. Each operator continues to have a monopoly in respect of call termination on its own network and, as things stand, the withdrawal of regulation would enable network operators to set termination charges without any effective competitive constraint, which would be likely to have a detrimental impact on consumer welfare and could lead to competitive distortions.

Physical and Bitstream Access (Markets 4 and 5)

The European Commission has proposed replacing the existing Market 4 with a new 'wholesale local access' market, which would comprise both physical unbundled access and virtual access. It has also proposed replacing the existing Market 5 with a new 'wholesale central access' market, comprising wholesale bitstream access.

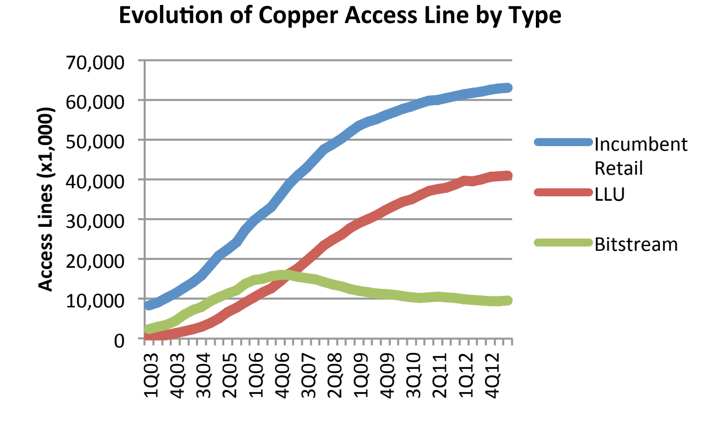
The regulation of physical access has proved to be one of the most effective actions by policymakers to encourage investment in differentiated and innovative services by entrants and incumbents alike. It therefore remains critical that entrants can continue to gain access to bottleneck physical assets on regulated terms, on a level playing field basis and at affordable prices.

Concerning the suggestion to include virtual access on higher speed technologies (fibre and/or vectored VDSL) within the same market as physical unbundled access, it is important to note that virtual access, while an essential access product for some market segments and particularly where the network topologies deployed by incumbent operators do not currently allow for physical unbundling, does not provide the opportunities for innovation that are critical to the market and that only physical unbundling products can offer. Virtual access products should therefore *not* be seen as a sufficient alternative to physical unbundled access. NRAs should consider the superior characteristics of physical unbundled access remedies (e.g. LLU, SLU and fibre unbundling) over virtual access remedies and impose and incentivise the use of physical access whenever possible as a matter of priority.

Nevertheless fit-for-purpose virtual access remedies, which emulate to the maximum extent the characteristics of physical access products, must be made available notably in those cases where physical unbundling is currently not possible.

The introduction of vectoring should also not be used as a justification for the withdrawal of SLU, which should continue to be available as a remedy to provide opportunities for alternative providers to roll-out FTTC. NRAs should identify rules for the coordination of ISPs willing to implement vectoring in the same cabinet area and to work with equipment vendors to resolve the technical issues to multi-operator vectoring.

It is also essential for a bitstream ADSL product to remain available and this should be mandated where it is not provided voluntarily on competitive terms. Around 10 million broadband users across Europe are still connected via wholesale bitstream and the withdrawal of bitstream may leave these consumers with no choice of broadband supplier. Further, bitstream access remains an important first rung on the ladder of investment that allows new players to enter the market and build up a customer base before making the larger investment need to develop a network based on LLU. Critically, bitstream access is also an essential input for the effective provision of services to business customers in many instances.



Data Source: Informa Telecoms and Media

It has been suggested that the wholesale central access market (which is proposed to replace the existing Market 5) should be defined on a sub-national basis by default and should only be regulated where there is insufficient competition based on LLU or other means of access[3]. We would make the following points in relation to the possibility of defining sub-national markets:

First, it is essential that any geographic market analysis is rigorous and based on hard evidence of competitive conditions in different areas. The fact that the specific national circumstances justified the definition of sub-national markets in the UK does not mean that such an approach would be justified in other EU Member States. Geographic markets should only be defined following a rigorous and evidence-based market analysis and a stringent test of availability of relevant upstream products and the use of upstream wholesale remedies.

Secondly, NRAs need to recognise that competition in business retail broadband markets is critically dependent on the existence of effective, and consistent, wholesale remedies across the whole country, due to the fact that multisite businesses typically purchase at

[3] Ecorys, Future electronic communications markets subject to ex ante regulation, Final report, 18 September 2013, p.24.

multiple locations (headquarters, other business sites and for home workers) and many of these sites may be outside the LLU footprint. Even if a business site is within an LLU provider's footprint, the LLU provider may only offer consumer broadband products.

Finally, if regulation is withdrawn in some geographic areas, this might give rise to the possibility for incumbents to engage in abusive behaviour, for example by using their pricing flexibility in unregulated areas to undermine competition from new entrants. NRAs should ensure that there is adequate and robust protection against this occurring before any move to sub-national markets.

Leased lines (Market 6) and Business Grade Bitstream

The European Commission has proposed a new 'wholesale high quality access' market, which would encompass both wholesale terminating segments of leased lines and other wholesale business grade access products.

It is important to note that wholesale bitstream access is unlikely to be substitutable for leased lines in most cases, given that such access typically provides asymmetric (rather than symmetric) upload and download speeds and uncontended (rather than dedicated) access.

We agree, however, to defining a separate market covering business grade bitstream access, which is distinct from the provision of mass market bitstream access, given the different competitive conditions in residential and business retail broadband markets. We note that two NRAs (in the Netherlands and Austria) have previously defined separate wholesale broadband access market for residential and business customers. In both cases, the incumbent was found to have SMP on a nationwide basis.

A much more detailed analysis of the requirements of business markets is included in other recent reports, in particular a report by WIK-Consult[4].

[4] WIK-Consult, "Business communications, economic growth and the competitive challenge", 16 January 2013.

Overall conclusion

The overall conclusion of this report is that, whilst there are opportunities for changes to the list of recommended markets, these changes are very limited. It is vitally important for the future of innovation and investment in the electronic communications sector that entrants continue to be able to gain access to key wholesale inputs on regulated terms, including LLU, SLU, WLR, CPS/CS and bitstream services.

There have been material gains under the present regime and these continue to be felt. Investment is increasing and consumers are paying prices, and benefiting from speeds, which compare well on international comparators. Now is not the time to rock the boat.

It is particularly important to continue to focus on regulating ongoing access bottlenecks and not to rush to remove markets from the list of relevant markets before the impact of changes in market dynamics are clearly demonstrated. Indeed, there is an argument that for those access services that remain bottlenecks, there is a greater need for regulatory rigour and attention from NRAs, notably in the transition to a Next Generation Access Networks (NGA) environment.