

Brexit: An opportunity to improve *ex ante* regulation?

- **The EU's *ex ante* regulatory framework has served the industry and consumers well**
- **But Brexit and the review of the regulatory framework is an opportunity to ask if it could be improved**
- **Market definition, timing and regulatory market design are three candidates**

The result of Britain's referendum on EU membership provides an opportunity to look back over the past 13 years of European regulation based on *ex ante* market reviews and ask a fundamental question: is it the best way to regulate the market or could it be improved on? With the European Commission reviewing the regulatory package as part of the Digital Single Market process, this question is relevant beyond the English Channel. This edition of Hexagon considers some strengths of, and possible improvements to, the EU's *ex ante* regulatory framework.

The EU's market review process was designed against a backdrop of incumbent former monopolies and sought to bring an economics approach to regulation, taking the methodology used in *ex post* competition law investigations and applying it up front. This rigorous approach ensures that markets are properly defined and only regulated if there is the potential for market failure caused by the presence of one or more firms with Significant

Market Power. Regulation can then facilitate efficient entry and competition.

The rigorous approach of the framework has ensured largely rational and apolitical regulatory decisions

Any review of the development of competition over the last 13 years would conclude that this approach has worked. The European Commission's list of relevant markets susceptible to *ex ante* regulation has been whittled down from 18, a third of which were retail markets, to just five: all wholesale. In some Member States some of these markets have been found to be effectively competitive in the whole country or in part and regulation removed.

Another great strength of the EU's *ex ante* framework is that it prevents the regulator from acting irrationally or too politically. Regulation must be evidence based and appeal

processes mean that if market players think regulation has been wrongly applied they can apply to a court or other tribunal for the decision to be changed.

So, there is much to consider successful about *ex ante* market reviews and, in particular, the EU's approach. But, thirteen years have also taught lessons that could and perhaps should be considered by policy makers in the UK, the EU and other countries that have adopted the methodology. The first two are specific to the EU framework, the last a more general comment on *ex ante* regulation.

First, the market-based approach means there is no opportunity within the framework for an overarching strategic review of markets. True, Ofcom has conducted two such reviews, but the implementation of the first relied on BT providing Undertakings under the Enterprise Act and the second review is to be implemented through the *ex ante* market review process. Would Ofcom have been able

to adopt a more optimal approach if it had powers to intervene outside market reviews?

Markets are always defined starting from the demand side: National Regulatory Authorities (NRAs) are told that the starting point of any market analysis should begin with products that are substitutable in that they can be used for the same purpose. This makes a lot of sense. However, it can mean that NRAs miss out on understanding how suppliers can use the same asset to serve different end user markets.

*Could overarching strategic analyses
complement relevant markets based reviews?*

Take, for example, how Ofcom has decided to promote duct and pole access to advance competition and fibre deployment in the residential broadband market, but has specifically excluded duct and pole access in its recent Business Connectivity Market Review in

favour of dark fibre. There may be demand-side justifications for such a decision, but from the supply-side it makes no sense as firms investing in new networks seek to achieve economies of scale by connecting customers to the network, regardless of whether they are houses, offices, shops or factories.

If NRAs were free from the constraints of the EU's *ex ante* market definition process and list of markets, would they be able to take a more holistic view?

*Could a strict three year cycle be made more
flexible to reflect market conditions?*

Secondly, under the EU framework NRAs are required to conduct market reviews every three years. This is an arbitrary time period and not necessarily appropriate for the market being reviewed. It is also the case that any remedies put in place are for the three year period.

For some markets that period may be appropriate. However, the further into the network the regulation reaches, i.e. the closer to pure infrastructure, the longer the investment and return cycles are likely to be. If NRAs are promoting infrastructure competition more time may be required between reviews to allow remedies that are put in place to support the development of sustainable competition.

Hypothetically, one can imagine a situation in which entrants or incumbents invest in infrastructure with a, say, ten year payback period, but the NRA imposes a charge control regulation for just three years. The lack of certainty over what the regulator may do with prices over a longer period could significantly affect firms' investment decisions.

If NRAs were not tied into a three year cycle, could the market review period be better linked to investment cycles?

The third potential weakness of the *ex ante* approach is that it gives NRAs the discretion to design market structures in their image based on their analysis of sustainable competition. This applies to *ex ante* regulation generally rather than the EU approach in particular.

Could remodelling the approach prevent regulators designing market structures inappropriately?

The NRA may decide that for competition to be sustainable, a minimum number of suppliers are needed in the market and so designs regulation to ensure this number, even if this could lead to inefficient investment. Alternatively, and in many ways worse, it may wrongly decide that a market is a natural monopoly and cannot sustain any competition. It could then impose regulation that has the effect of excluding efficient investment by other firms.

If the NRA adopts regulation that makes market entry too easy, and thereby encourages inefficient investment, the normal processes of the market will correct this error and the weakest firms will exit the market. However, if regulation deters efficient competitive investment, leaving the incumbent unchallenged, only the NRA or the courts can correct this error. By then it might be too late.

The success of *ex ante* regulation to date suggests it should be left in place, but could some remodelling of the approach prevent regulatory market design?

Overall, the *ex ante* approach has served the industry, and more importantly consumers, well. But as the UK and, to some extent, the EU and other countries have the opportunity to review the situation we should take that opportunity and improve the process.