

# REPORT ON THE REVIEW OF THE EUROPEAN REGULATORY FRAMEWORK FOR ELECTRONIC TELECOMMUNICATION

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### 1. Initial situation: the existing regulatory framework

The current **EU regulatory framework** for electronic communications networks and services, valid since 25 July 2003, currently **encompasses**

- a **Framework Directive**,
- **five Accompanying Directives**,
- a **Market Recommendation** by the Commission **and**
- the Commission **Guidelines** for market analysis and assessment of significant market power.<sup>1</sup>

In its initial considerations, in 1999 the European Commission emphasised the **provisional nature** of this sector-specific regulation. The regulatory framework, according to the Commission, "*addresses the need to create a competitive market. (...)Once a competitive market is effectively established, many of these provisions should no longer be necessary and it would therefore be sufficient to rely mainly on the application of the competition rules of the Treaty. The new framework should therefore build in mechanisms such as "sunset clauses" whereby certain basic rules are reviewed periodically to assess whether they are still necessary.*"<sup>2</sup>

The currently valid framework directive provides for an **ex ante regulation** in the telecommunications sector **only in the absence of effective competition**. This refers to markets "*where there are one or more undertakings with significant market power, and where national and Community competition law remedies are not sufficient to address the problem.*"<sup>3</sup> The definition of "significant market power" follows the concept of dominance in competition law according to pertinent jurisprudence by the European Court of Justice. Accordingly, an undertaking has significant market power if "*either individually or jointly with others it enjoys a position equivalent to dominance, that is to say a position of economic strength affording it the power to behave to an appreciable extent independently of competitors, customers and ultimately consumers.*"<sup>4</sup>

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<sup>1</sup> Directive 2002/21/EC of the European Parliament and of the Council of 7 March 2002 on a common regulatory framework for electronic communications networks and services; Directive 2002/19/EC of the European Parliament and the Council of 7 March 2002 on access to, and interconnection of, electronic communications networks and associated facilities (Access Directive); Directive 2002/20/EC of the European Parliament and the Council of 7 March 2002 on the authorisation of electronic communications networks and services (Authorisation Directive); Directive 2002/22/EC of the European Parliament and of the Council of 7 March 2002 on universal service and users' rights relating to electronic communications networks and services; Directive 2002/58/EC of the European Parliament and of the Council of 12 July 2002 concerning the processing of personal data and the protection of privacy in the electronic communications sector; Commission Directive 2002/77/EC of 16 September 2002 on competition in the markets for electronic communications networks and services; Commission Recommendation 2003/311/EC of 11 February 2003 on relevant product and service markets within the electronic communications sector susceptible to ex ante regulation in accordance with Directive 2002/21/EC of the European Parliament and of the Council on a common regulatory framework for electronic communication networks and services; Commission guidelines on market analysis and assessment of significant market power under the Community regulatory framework for electronic communications networks and services, OJ C 165 of 11 July 2002, p. 6.

<sup>2</sup> COM(1999)539, Communication from the Commission to the European Parliament, the Council, the Economic and Social Committee and the Committee of the Regions on a new framework for electronic communications infrastructure and associated services – Commission Report 1999", p. 12.

<sup>3</sup> Framework Directive 2002/21/EC, Recital 27.

<sup>4</sup> Framework Directive 2002/21/EC, Art. 14 (2).

As well as referring to market dominance as a concrete criterion for regulation, the framework directive also specifies that the Commission, in compliance with the principles of competition, shall identify the markets susceptible to such regulatory obligations.<sup>5</sup> In a **market recommendation** in 2003, the Commission identified **18** such **telecommunications markets**.<sup>6</sup>

In this recommendation, the Commission also explains the so-called "**three-criteria test**" for stipulating the need for regulatory obligations in a specific market. The Commission stipulates that markets can be regulated if

- (1) there are persistently high structural, legal or regulatory impediments to access,
- (2) the markets do not show a tendency towards effective competition of their own accord, and
- (3) market failure cannot be counteracted by applying competition law alone.

The criteria are applied **accumulatively to one market representative for all Member States**. All three criteria have to be fulfilled on this representative market, before the corresponding market in all Member States can be susceptible to ex ante regulation.

Taking the "utmost account" of this Commission recommendation, the national regulatory authorities define relevant markets on a national scale ("**market definition**"),<sup>7</sup> whereby the Commission recommendation is virtually binding in character. There is no provision for a review by the national regulatory authorities using the three-criteria test to ascertain whether the structure of a national market – and not only that of the representative market considered by the Commission – justifies regulatory obligations.<sup>8</sup>

Following this market definition, the national regulatory authorities analyse the concrete situation on the defined national market, looking at whether there is effective competition on the corresponding market, and which companies have significant market power ("**market analysis**").<sup>9</sup>

If the national regulatory authority concludes that there is no effective competition, then an **ex-ante regulation** has to be imposed on the affected undertakings with significant market power (e.g. obligation to keep separate accounts, transparency obligations, price controls or the obligation to grant access to the network infrastructure). If the national regulatory authority is of the opinion that there is effective competition in the market, no ex-ante regulation has to be imposed.

The market definitions and market analyses of the national regulatory authorities together with the resulting specific ex-ante regulations are subject to the so-called **Article 7 procedure**.<sup>10</sup> Insofar as the regulatory

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<sup>5</sup> Framework Directive 2002/21/EC, Art. 15 (1).

<sup>6</sup> Commission Recommendation 2003/311/EC of 11 February 2003 on relevant product and service markets within the electronic communications sector susceptible to ex ante regulation in accordance with Directive 2002/21/EC of the European Parliament and of the Council on a common regulatory framework for electronic communication networks and services.

<sup>7</sup> Framework Directive 2002/21/EC, Art. 15 (3).

<sup>8</sup> In Germany, Art. 10 (2) Telecommunications Act (TKG) stipulates that the Federal Network Agency also reviews the regulation needs of a market. While the Federal Network Agency may refute the regulation needs stipulated by the Commission, "such refutation does however have to meet very high requirements. (...) [It] would entail demonstrating that even the typical characteristics of the specific market in Germany deviate from a European average to such an extent that it is possible to rule out already the possibility of a need for regulation (...)." (Stipulation by the Federal Network Agency: "Terminierungsleistungen alternativer Teilnehmernetzbetreiber im öffentlichen Festtelefonnetz" of 12 October 2005, BK 1-04/002a, own translation).

<sup>9</sup> Framework Directive 2002/21/EC, Art. 16.

<sup>10</sup> Pursuant to Art. 7 of the Framework Directive 2002/21/EC.

measures affect trade between the Member States, the national regulatory authorities have to provide the Commission and the other national regulatory authorities with justified drafts of these regulations. The Commission and the national regulation authorities can submit a reaction within one month. As a rule, the Commission presumes that the planned measures will have effects on interstate trade, so that notifying the Commission of planned national measures according to Article 7 has practically become the standard procedure.

If a national regulatory authority wants to

- define a market deviating from the Commission recommendation or
- decide in the framework of the market analysis to what extent an undertaking has significant market power,

and if the Commission sees this as a barrier to the Single Market, then the period for submitting a reaction is extended by two months. In these cases, the Commission has a so-called "**veto right**". It can take a decision requiring the national regulatory authority not to take the disputed decision.<sup>11</sup> The Commission's veto right is restricted to the case of deviating market definition and the question as to what extent an undertaking has significant market power (within the market analysis). In terms of concrete regulatory measures, the Commission does not have a veto right. Nor does the Commission have the power to order regulatory obligations itself.

## 2. Proposals of the Commission for reviewing the sector-specific ex-ante regulation

Article 15 (1) of the framework directive stipulates that the Commission regularly reviews its recommendation on the markets susceptible for ex-ante regulation. The Commission is currently carrying out such a review and has presented a **draft for a reviewed recommendation**.<sup>12</sup> This document emphasises the role of the three-criteria test: the Commission says that the regulation has to be revoked if effective competition will probably prevail even without regulation.<sup>13</sup> Creating such sustainable competition on wholesale markets benefits the retail customer and is an explicit objective of the ex-ante regulation.<sup>14</sup>

In its recommendation, the Commission emphasises that the national regulatory authorities can assume that the markets of the Commission recommendation fulfil the three-criteria.<sup>15</sup> If the regulatory authority proves to the Commission that the three criteria are not fulfilled in a certain situation, then the regulatory authority can waive an ex-ante regulation.<sup>16</sup> There is no indication as to whether the reverse situation results in an obligation to revoke an existing regulation.

In its draft recommendation, the Commission concludes that effective competition prevails on **five final customer markets** where there is **no longer the need for ex-ante regulation**. Regulatory obligations are no longer imposed on these five final customer markets:

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<sup>11</sup> Framework Directive 2002/21/EC, Art. 7 (4).

<sup>12</sup> See: Commission Staff Working Document on a Draft Commission Recommendation On Relevant Product and Service Markets within the electronic communications sector susceptible to ex ante regulation in accordance with Directive 2002/21/EC of the European Parliament and of the Council on a common regulatory framework for electronic communication networks and services (Second edition), SEC (2006) 837 dated 28 June 2006.

<sup>13</sup> Draft Commission Recommendation SEC(2006) 837 dated 28 June 2006, Recital 17.

<sup>14</sup> Id., Recital 2.

<sup>15</sup> Id., Recital 16.

<sup>16</sup> Id.

- Public local and/or national telephone connections for private customers and other customers at fixed locations (markets 3 and 5);
- Public international telephone connections for private customers and other customers at fixed locations (markets 4 and 6) and
- The minimum supply of leased connections (market 7).

When it comes to the question of imposing an ex-ante regulation on "emerging markets", the Commission draws attention to the fact that such markets are so new and their development so unpredictable that it is not possible to decide whether they fulfil the three-criteria test. The need for regulation in these markets can only be estimated after a certain period of time.<sup>17</sup>

### 3. Proposals of the Commission for institutional alterations in the regulatory framework

Together with the draft for a reviewed market recommendation, the Commission has also presented a **Communication on the review of the EU telecommunications regulatory framework**.<sup>18</sup> In the communication, the Commission not only endeavours to a large extent to continue sector-specific regulation, but also proposes **important institutional alterations**. This focuses primarily on the procedure according to Article 7, already explained on page 3. The Commission's proposals are explained briefly below.

#### 3.1. Administrative workload

In its considerations to review the regulatory framework, the Commission is endeavouring to change the notification procedure according to Article 7 of the framework directive. The Commission is of the opinion that the procedure constitutes *"an important step towards the creation of an internal market for electronic communications"*.<sup>19</sup> The Commission sees its role as being crucial in that it safeguards consistent application of the regulation throughout the EU.

In its communication on the review of the regulatory framework, the Commission firstly proposes **reducing** the **administrative workload** of the Article 7 notification procedure and **simplifying** the **communication requirements** for regulatory authorities for the drafts of certain national measures. While in the opinion of the Commission, the regulatory authorities should still carry out market analyses together with consultations, it wants to introduce a simplified notification procedure for certain cases with a standardised notification form.

The procedure should be used for:

- markets where the national regulatory authority already ascertained effective competition in an earlier analysis and where there have been no substantial changes;
- minor changes to measures that have already gone through the procedure as per Article 7.

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<sup>17</sup> Id., p. 17.

<sup>18</sup> Communication from the Commission to the Council, the European Parliament, the European Economic and Social Committee and the Committee of the Regions on the Review of the EU Regulatory Framework for electronic communications networks and services. COM (2006) 334 final dated 29 June 2006.

<sup>19</sup> Id., p. 8.

In the short term, the **Commission** is aiming for a new version of its (non-binding) procedure recommendation so that the simplified procedure can come into effect before the end of 2007.<sup>20</sup> In the long-term, the Commission **wants** to change the framework directive so that **it is given the authority to regulate the simplified procedure itself with a binding Commission Regulation**. This would summarise all procedural provisions in one single, binding specification. This Commission Regulation would replace parts of the framework directive and stipulate **binding time limits**, e.g. for completing market analyses, ordering regulatory measures and revoking the planned measures.<sup>21</sup>

Secondly, in this Regulation the Commission would also like to **stipulate** so-called "**minimum standards**" for the Article 7 procedure. The central issue is the **obligation** of the national regulatory authorities **to notify** the Commission of the **market definitions, market analyses and resulting measures in one package**.

The Commission complains that certain regulatory authorities tend to use several phases to fulfil their notification obligations. To start with, they report the market definition with or without market analysis, followed in a second phase by the suggested measures, or the market analysis and the suggested measures. The Commission sees this as being inefficient and would like the Commission Regulation to specify that the regulatory authorities notify the Commission of their market definitions, market analyses and suggested measures in a "package".

Thirdly, as a means of simplifying the administrative workload, the Commission proposes that the national regulatory authorities **only have to conduct a new market analysis in the case of substantial changes on the market**. By contrast, the existing regulatory framework does not specify when a market has to be analysed again. As a further means of relieving the workload on the regulatory authorities, the Commission also proposes that the **burden of proof for such a new market analysis should be placed on the affected undertakings**, who should convince the regulatory authorities of the need for a reviewed market analysis.

### 3.2. Commission veto to strengthen the Single Market

The Commission is of the opinion that while the Article 7 procedure has contributed to increasing the consistency of market definitions and market analyses, there is still scope for improvement in the consistency of the measures for the specific regulation taken by the regulatory authorities on the basis of the market analysis. The Commission criticises that the Member States have not always taken the same regulatory measures for identical market problems.

The Commission pleads in favour of expanding its veto right as a "contribution to the development of the Single Market". Up to now, the **Commission** only has a veto right on certain decisions by the regulatory authorities on market definition and market analysis (judging the presence of effective competition). In the future, it **wants to be able to veto the concrete proposals of the regulatory authorities for specific ex-ante regulation**. However, the Commission would still not have the power to order regulatory provisions.

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<sup>20</sup> Referring to Commission Recommendation 2003/561/EC dated 23 July 2003.

<sup>21</sup> See: letter from Commissioner Reding to the European Regulators Group of 30 November 2006. [http://ec.europa.eu/information\\_society/policy/ecomms/doc/info\\_centre/com\\_erg\\_discussion/061130\\_vr\\_letter.pdf](http://ec.europa.eu/information_society/policy/ecomms/doc/info_centre/com_erg_discussion/061130_vr_letter.pdf).

### 3.3. Suspensive effect and appeals procedure

The hitherto valid framework directive stipulates that an appeal against a sector-specific regulation by a regulatory authority does not have any suspensive effect, unless decided otherwise by court. The Commission criticises the lengthy duration of many court procedures and the fact that in certain Member States, the courts prescribe a suspensive effect as a matter of routine. This gives certain undertakings the incentive to misuse the appeals procedure as delaying tactics, and prevents the Single Market from functioning smoothly.

In this context, the Commission would like the framework directive to specify that the **suspensive effect** can **only** be prescribed **for irreparable damage of the appellant**. The Commission hopes that this will harmonise the treatment of applications for suspensive effect and reduce abuse of the appeals procedure.

## 4. Structural and functional separation

One special issue in the network industries such as the telecommunications or energy sector is how to deal with vertically integrated undertakings. Such undertakings refer to operators of facilities (telephone networks, power lines, etc.) which at the same time also offer products or services to retail customers. Concerns about the quality of competition arise from the fact that a company needs access to these facilities in order to offer products or services to the retail customer market. Under certain circumstances, the vertically integrated undertaking, which also operates on the retail customer market, may not have any incentive to grant such access at prices in line with market conditions.

With regard to vertically integrated undertakings in the energy and telecommunications sector, the Commission is considering whether to bring about a separation between infrastructure and services in such undertakings, looking at two possible forms of separation.

The first refers to **structural separation**: this consists of mandatory separation of network and services in terms of property rights.

The second form of separation is **functional separation**. This does not entail intervention in terms of property rights but demands that vertically integrated companies set up operationally separated business units. There must be strict separation between the management of the network and the management of the retail customer business, for example using separate staff not bound by instructions. The aim of such functional separation is to guarantee that all suppliers on the retail customer level have non-discriminatory access to the network of the vertically integrated undertaking, in line with market conditions.

The Commission argues that structural separation can be of interest particularly when the networks are not yet very far developed. Mandatory access regulation following such separation would, in the view of the Commission, guarantee non-discriminatory access to the network. The specified low access price would give the infrastructure operator security in the form of a low yield over a long period of time.

However, in its impact assessment on the Communication, the Commission is **not convinced that structural separation is suitable for the telecommunications sector**.<sup>22</sup> The Commission is of the opinion that the costs of such structural separation exceed the benefits. Separating the telecommunications infrastructure from operations fails to solve many problems, in the view of the Commission. Even after structural separation, there would still be a need to regulate the prices for access to the "local loop". Secondly, the separation of infrastructure and services would create an incentive problem when it comes to investing in the network infrastructure. Particularly in the telecommunications industry with its rapid rate of technological change, this would cause considerable coordination problems, in the view of the Commission. The Commission comes to the conclusion that **complete structural separation between network infrastructure and net-based services would not be feasible with the existing directives**. Under certain circumstances, structural separation could be brought about by competition law.<sup>23</sup>

In contrast to these negative evaluations, Viviane Reding, EU Commissioner for Information Society and Media, is more in favour of an alternative separation of infrastructure and service. In recent speeches she has focussed on the **functional separation model**.<sup>24</sup> Reding is therefore opting less for separation in terms of property rights and more for separating network management from management of the services using the network. According to the Commissioner, such separation "would permit non-discriminatory network access without changing the proprietary situation in the networks."<sup>25</sup> The Commissioner seems to be willing to differentiate: "Functional separation will not be considered in areas where there is already effective infrastructure competition."<sup>26</sup>

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<sup>22</sup> See Impact Assessment of the Commission on Communication by the Commission on the Review of the EU Regulatory Framework for electronic communication networks and services, SEC (2006) 817 dated 28 June 2006, page 11.

<sup>23</sup> Id.

<sup>24</sup> See among others: "Telecommunications Markets in Europe: Growth and Investment need competition", Speech by Viviane Reding at the 10<sup>th</sup> General Assembly of the Belgian Platform Telecom Operators and Service Providers, Brussels, 21 March 2007.

<sup>25</sup> See: Viviane Reding, "Europas Telekommunikationsmarkt vor der Reform des EU-Rechtsrahmens", Speech at the 13th international Handelsblatt annual conference "Telekommarkt Europa" Düsseldorf, SPEECH/07, 12 June 2007.

<sup>26</sup> Id.

## ASSESSMENT

### 1. Ex-ante regulation in terms of an ordo-liberal regulatory policy

#### 1.1 Introduction

Nearly ten years after introducing sector-specific ex-ante regulation of the telecommunications sector, this issue has not lost any of its political appeal. Nor is the European Commission striving for any paradigm change in the pending review of the EU regulatory framework for electronic communication. The Commission would like the **new EU regulatory framework** for electronic telecommunication to be **based fundamentally on sector-specific ex-ante regulations, as before**. This holds on to the basic philosophy of the existing regulatory framework, opting for sector-specific ex-ante regulation to a great extent.

**In terms of an ordo-liberal regulatory policy, such sector-specific ex-ante regulation requires a conclusive and convincing justification.** It encroaches extensively on entrepreneurial liberties and on the organisation of the market, and may not become an end in itself. Regulation results among others in prices being stipulated by the authorities instead of the market. Individual companies are obliged to grant their competitors access to parts of their own infrastructure, which they would scarcely do on a voluntary basis.

The European Commission justifies sector-specific ex-ante regulation with the objectives of competition policy. According to the Commission, the regulation aims to create permanent competition on the retail customer markets, in the end also benefiting the retail customers.<sup>27</sup> But the Commission only sees ex-ante regulation as an interim solution, and aims to gradually dismantle sector-specific regulation with progressing competition on the telecommunications markets.<sup>28</sup>

In terms of an ordo-liberal regulatory policy, it is indeed a task of the legislator to create a regulatory context that makes free competition possible in the first place, and secures its existence. **The next question then arises as to whether and under which concrete prerequisites such a regulation is justifiable.**

#### 1.2 Sector-specific ex-ante regulation in terms of an ordo-liberal regulatory policy

The prerequisites under which market intervention by public regulation can be recommended are clearly defined in Network Economics. **The theory of monopolistic bottlenecks** supplies the prerequisite that make ex-ante regulation necessary and desirable from the point of view of Network Economics, because of network-specific market power. In all other cases, regulation is superfluous, since the application of competition law is sufficient.

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<sup>27</sup> "The objective of any ex-ante regulation intervention is ultimately to produce benefits for end users by making retail markets sustainably competitive." proposal of the Commission Recommendation, SEC (2006) 837, Recital 2.

<sup>28</sup> Id. Recital 1.

The starting point for the theory of monopolistic bottlenecks is the concept of "market access barriers" defined by Stigler already in 1968.<sup>29</sup>

Stigler defines market access barriers as production costs incurred by a new provider on the market but not by an already established competitor. Such market access barriers can indicate the possible presence of a network-specific market power. Scale effects (cost savings from higher production) or the need for high start-up capital are therefore not considered to be market access barriers, as they affect market newcomers and existing providers to the same extent.

Continuing with Stigler's concept, according to the theory of monopolistic bottlenecks, **ex-ante regulation of a network facility is only permitted if this facility is indispensable for the provision of products or services to the final customers and there are neither active nor potential alternatives to the facility**.<sup>30</sup>

This means on the one hand that there is no second, comparable facility. This is the case for natural monopolies with cost subadditivity. Here, falling average costs or increasing scale revenues can result in the possibility of offering the product at lower costs if it comes from only one provider instead of several. If there are alternatives ("substitutes") to a facility so that a provider can reach the final customers by other means, then it is no longer possible to speak of a market power. Competition between these facilities prevents the providers from being able to demand monopoly prices. Hence, in this case, there is no need to bring about competition by means of ex-ante regulation.

But the existence of a natural monopoly is not a sufficient justification for ex-ante regulation. The "concept of contestable markets"<sup>31</sup> stipulates that even in the presence of a natural monopoly, regulation is only necessary and justifiable if there is no possibility of credibly "threatening" with the set-up of an alternative facility. If such a threat were credible, no regulation would be necessary. In this case, the natural monopolist cannot demand monopoly prices without fearing the entry of a second, cheaper provider onto the market. Regulation would therefore not be necessary in this case, as the threat of new market entries forces the natural monopolist to behave according to the dictate of the market. Regulation would only have negative effects, causing costs for bureaucracy and distorting investment incentives.

However, the threat of new market entries is not credible when market access barriers exist as defined by Stigler. The entry of new providers onto the market cannot be expected in particular when these are faced with high irreversible costs (so-called sunk costs). This is the case when there is no other use for the components of a facility. It takes a combination of a natural monopoly (no active competition) and high irreversible costs (no potential competition) to result in a stable, network-specific market power, justifying regulation. In this case, the absence of regulation means that a provider can permanently demand monopoly prices without having to fear competition from new providers entering the market.

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<sup>29</sup> Stigler (1968) *The Organization of Industry*, Irwin, Homewood, Illinois.

<sup>30</sup> For a detailed description of this theory, see: G. Knieps, G. Brunekreeft, (Hrsg.), *Zwischen Regulierung und Wettbewerb – Netzsektoren in Deutschland*, Physica-Verlag, Heidelberg, 2000.

<sup>31</sup> For details see: Baumol, Panzar and Willig, *Contestable Markets and the Theory of Industry Structure*, 1982.

**In terms of an ordo-liberal regulatory policy, sector-specific ex-ante regulation can therefore only be justified when there is a natural monopoly combined with irreversible costs.** If these prerequisites are not fulfilled, regulation is superfluous and can even have detrimental effects: without a natural monopoly combined with irreversible costs, an inefficient provider would not be capable of surviving on the market in the long term or demanding monopoly prices, regardless of market power or market share.

### 1.3 "Three-criteria test" instead of the theory of monopolistic bottlenecks

The European regulatory framework for electronic communication imposes ex-ante regulation on a network sector which is of great significance for Europe's national economies. The aim of the regulation: the establishment and safeguarding of sustainable competition on the telecommunications markets is worthy of support. However, the question arises whether the means being used (ex-ante regulation) are necessary and actually bring about the intended objective (sustainable competition).

This is important as by regulating, two mistakes can be made which burden the economy with costs:

1. Mistake Type I: Regulations are imposed although there is no need for them. Competition would function without any regulation and is distorted by the unnecessary regulation.
2. Mistake Type II: No regulation is imposed, although there is a need for it (e.g. because of network-specific market power). There is no sustainable competition, resulting in inflated prices.

In order to avoid such costs, it is **essential for the European regulatory framework to contain criteria which always and only prescribe a regulation if it is necessary. In this point in particular, the regulatory framework reveals major weaknesses which the Commission has still not eliminated in its proposals for reviewing the regulatory framework.** In justifying sector-specific ex-ante regulation, the Commission uses the so-called "three-criteria test"<sup>32</sup> instead of the concept of network-specific market power. This three-criteria test decides whether a market is regulated and is therefore particularly important. **In the way it is currently being used, the three-criteria test cannot justify an ex-ante regulation for the following three reasons:**

- (1) the test lacks a substantiated theoretical and scientifically sound basis,**
- (2) the test is not carried out in an econometrically justifiable manner, and**
- (3) the test is not applied to every single national market.**

(1) Firstly, **the test is lacking any substantiated theoretical and scientifically sound basis.** Although it takes up certain elements of the theory of monopolistic bottlenecks, it **leaves so much scope for inaccuracies** that it can be used to "justify" imposing a regulation for non-economic reasons.

To avoid such excessive regulation, the test has to be put in more precise terms and brought into line with the theory of monopolistic bottlenecks. This includes among others clarifying under which conditions the test is used on new markets, and what exactly the test means by "access impediments".

The Commission is of the opinion that new markets are so new and volatile that it is not possible to use the three-criteria tests for these markets. As a result, the Commission also fails to answer the question as to

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<sup>32</sup> See explanations on page 3.

whether, how and when such markets are to be regulated. Given the significance of these markets, the Commission should eliminate this regulation uncertainty by clearly defining what is meant by "new markets" and presenting a conclusive concept of the circumstances under which these markets are to be regulated.

As far as access impediments are concerned, the Commission mentions regulatory impediments and structural impediments as a result of network externalities or scale effects. Here the Commission deviates from the theory of monopolistic bottlenecks and nurtures doubts as to how it defines these market entry impediments. The statements made by the Commission are contradictory. While on the one hand it recognises the disciplinary effect of potential competition from not yet existing providers, on the other hand it specifies that national regulatory authorities should examine the presence of access hindrances by ascertaining whether there have actually been frequent and successful market entries in the past, and whether these will take place soon enough in the future and be sufficiently long-standing.<sup>33</sup>

The **Commission** thus **permits politically motivated interventionism** in applying the three-criteria test and thus **in the decision on whether to regulate a market**. The Commission fails to consider that the question whether frequent and successful market entries have taken place or are to be expected, is irrelevant for the question whether regulation is necessary. Even the credible threat of potential competitors can force a company with market dominance to behave in compliance with the market. In this case there is no need for regulation, although no market entries have taken place.

(2) Secondly, a test is only appropriate if carried out by appropriate means. This **entails carrying out the test in an econometrically justifiable manner**. Up to now, the Commission has not presented such an econometric analysis that can stand up to precise verification.

(3) Thirdly there are great problems in the way the **Commission applies the test to a "European average market" and not to every single national market**. This cannot constitute an adequate justification for such a far-reaching regulation as sector-specific ex-ante regulation. Given the great differences in the structures of the corresponding national telecommunications markets, it is essential for a regulation to be applied only and always when the test applied to the *national* market confirms the need for regulation.

Active, far-reaching intervention in the market always needs special justification every time, based on precisely stipulated criteria. The three-criteria test fails to supply such justification for the three reasons stated above.

#### **The test cannot ensure that the correct extent of regulation is imposed.**

In addition to the resulting losses in efficiency, excessive regulation (Mistake type I) also conceals the danger of consolidating the regulation. If regulations are applied without any need, it cannot be ruled out that particularly this regulation deprives market participants of the incentive to invest (for example in alternative facilities). Accordingly, the regulation prevents the market from showing a tendency to more competition of its own accord, and thus automatically ensures its own continuance. Every time the situation is reviewed, the

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<sup>33</sup> Draft Commission Recommendation SEC(2006) 837 dated 28 June 2006, Recital 9.

fact that not enough has been invested in alternative facilities is taken as evidence of market entry impediments. No consideration is given to the fact that it is the regulation itself which prevents such investment. Nor can the test prevent faults of type II (inadequate regulation).

However, an analysis of the planned institutional alterations presented in the following section makes it clear that it is **above all excessive regulation which is to be feared**. The risk of excessive regulation applies all the more in view of the fact that the telecommunications sector is subject to competition law anyway, even without sector-specific ex-ante regulation.

Competition law checks whether market dominance is being misused. It differs fundamentally from sector-specific ex-ante regulation. Firstly, competition law applies to (nearly) all sectors of the economy and is therefore not sector-specific. Secondly, in contrast to ex-ante regulation, it does not try to predict how the markets will function. With competition law, price, demand, supply or other market trends are not forecasted by the authorities but used afterwards (ex post) to assess the question whether market dominance is being misused. With its deterrent effect, competition law is already capable of preventing such misuse beforehand (ex ante).

**Conclusion:** Sector-specific ex-ante regulation cannot be the norm and therefore needs special justification. The three-criteria test reveals considerable operational deficits and therefore cannot supply adequate justification for a regulation.

## 2. Institutional questions

In its communication pertaining to the review of the EU regulatory framework for telecommunications, the Commission proposed some institutional alterations to the regulatory framework, commenting above all on the future configuration of the Article 7 procedure.<sup>34</sup> The following section analyses these proposals.

### 2.1 Fundamental considerations

When looking at the proposals made by the Commission for reviewing the regulatory framework and the proposals for procedural alterations, fundamental consideration must be given to the **double institutional role of the Commission**. According to the EC Treaty, in the legislative process the Commission has an extensive sole right of initiative and thus plays a crucial role. At the same time, the Commission is directly affected by the legal instruments it suggests itself, to the extent that these increase its influence. While the EC Treaty stipulates that the Commission must perform its activities to the collective well-being of the Community,<sup>35</sup> on the other hand Niskanen's theory of bureaucracy<sup>36</sup> – according to which every authority tries to increase its influence – can also be said to apply to the Commission. Given the double role of the Commission as both initiator and beneficiary of a regulation, **it can hence be assumed that the Commission's proposals** to review the regulatory framework for telecommunications **are intended not**

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<sup>34</sup> Communication from the Commission to the Council, the European Parliament, the European Economic and Social Committee and the Committee of the Regions on the Review of the EU Regulatory Framework for electronic communications networks and services. COM (2006) 334 final dated 29 June 2006.

<sup>35</sup> Art. 213 (2) ECT.

<sup>36</sup> Niskanen, William (1971) Bureaucracy and Representative Government. Chicago: Aldine-Atherton.

**primary to address the collective good of the Community but to enhance the Commission's own competencies.** This is why it is particularly appropriate to take a critical look at the institutional issues of the regulatory framework.

## 2.2 Changes to the Article 7 procedure

(1) The Commission proposes that the review of the regulatory framework should also include a "simplification" of the procedure pursuant to Article 7 of the framework directive. **The national regulatory authorities should be able to use a simplified procedure in the notification of markets where competition has already been ascertained in the past, and for minor changes in existing regulatory measures.**

While the Commission's argument that this reduces the bureaucracy costs may be correct, the savings involved are incurred above all **by the regulatory authorities and not by the affected companies.**

Secondly, it is important to note that as a side effect of the simplified procedure, in the case of minor changes to existing regulatory measures, the regulatory authorities can **prolong** the existing regulation **with little workload and costs.** As there is no clear definition of "minor changes", there are grounds to fear that this in the end will bring down the hurdles for further regulation. **The problem with this is that it increases the negative consequences of the three-criteria test.** Not only does this test fail to provide adequate justification for a regulation: the Commission's proposed changes make it easier for the already implemented regulation to remain in force.

(2) This is even clearer in the Commission's proposal that the national regulatory authorities **only conduct a new market analysis in the case of substantial changes on the market – which have to be verified by the affected companies.** This proposal opens the doors to inadmissible actions in terms of an ordo-liberal regulatory policy, inadmissibly reversing the burden of proof. It is the legislator who has to verify the need for regulation, and not the person, entity or company concerned. **Shifting the costs for revoking the regulation to the companies cannot be accepted.** It is clearly the task of the sovereign regulator to assume responsibility for the issued regulation and to constantly review the corresponding on-going need.

### **Conclusion:**

The two proposals made by the Commission relieve the burden on the national regulatory authorities in the notification procedure and in carrying out new market analyses. This tends to strengthen existing regulations. The problem with this is that the regulation is a result of the inadequate three-criteria test. Additionally, it can not be ruled out that in reinforcing the regulation, the Commission as co-regulator is pursuing its own interests.

(3) A further indication of such motive can also be found in the Commission's proposal to change the Article 7 procedure in such a way that the national regulatory authorities are to report their market definitions, analyses and ensuring regulatory measures to the Commission as a package. The Commission argues that

this **introduces "minimum standards" for the notification procedure and enhances the consistency of the resulting regulatory measures. As a result, these "minimum standards" might give the Commission an opportunity to expand its veto rights.**

In this way, the Commission will practically be in a position to expand its already existing veto right in terms of market definition and the decision on market power to include the regulatory measures of the national regulatory authorities. Although the Commission does not have a veto on national authorities' regulatory measures, it could prevent a national regulatory measure of which it does not approve of by vetoing the market definition which is also included in the same package.

While the Commission's proposal could accelerate the notification procedures, two arguments against this institutional proposal made by the Commission in terms of its content should be mentioned. Firstly, the Commission already has the possibility of proceeding (as stipulated in Article 226 EC-Treaty) against national regulatory measures which it believes to be inadmissible on the basis the EC-Treaty. As guardian of the Treaties, it is even the Commission's duty to proceed in this manner.<sup>37</sup> The fact that the Commission is willing to make use of this possibility was illustrated recently by the VDSL-debate with Germany.

Secondly, there is a risk that the Commission will confuse "consistency" with "harmonisation" and use its veto right to harmonise the varying national regulatory measures. Uniform regulatory measures in the 27 different telecommunications markets cannot be worth pursuing already in view of the differing market constellations and specific national circumstances.<sup>38</sup> These differences are negated by the Commission in taking only an "average European market" as the basis for the three-criteria test.

(4) The Commission's proposal that it should be authorised to regulate procedural issues arising from Article 7 in the future by a binding Commission Regulation is to be seen as an attempt to expand its competencies. In fact, the Commission only sees two possibilities for safeguarding a "more consistent application of the regulatory framework": **expanding the competencies of the Commission, or creating a European regulatory authority.**<sup>39</sup>

As indicated in a letter from Commissioner Reding of 30 November 2006 to the European Regulators Group, the Commission is planning to expand its competencies to include the right to demand that national regulation authorities proceed with market analyses and implement regulatory measures within an appropriate period of time. This can be expected to result in more regulation, not less. The intended possibility for the regulatory authorities to waive the need for market analysis (and thus for ex-ante regulation) if they are of the opinion that the three-criteria test is not fulfilled in a certain situation, would thus become null and void.<sup>40</sup>

There is a risk here that the national regulatory authorities will become the executing agents of the Commission, although the specific competencies regarding the national markets lie more with the national regulatory authorities than with the Commission.

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<sup>37</sup> Art. 211 ECT.

<sup>38</sup> For example, the telecommunications markets of the new EU Member States cannot be compared with those of the established EU countries, given the structural differences pertaining to the substitution between landline telephony and mobile telephony.

<sup>39</sup> See: SPEECH/07/86: speech by Vivianne Reding: "Towards a true internal market for Europe's telecom industry and consumers – the regulatory challenges ahead" of 15 February 2007.

<sup>40</sup> Id.

The attempt to centralise the regulation is clearly illustrated by the Commission's efforts to turn the "European Regulators Group" (ERG) which it called into being with representatives from the national regulatory authorities, into a federal system of regulatory authorities along the lines of the European System of Central Banks (ESCB).<sup>41</sup> The ERG has a permanent Secretariat at the Commission in Brussels.

### 2.3 Commission's veto right

Together with the Commission's efforts mentioned above to demand "package reports" made of market definitions and analyses together with regulatory measures, and thus practically to expand its existing veto right to the regulatory measures of the regulatory authorities, in the framework of its "efforts to consolidate the Single Market", the Commission proposes that it is given a **right to veto regulatory measures proposed by the national regulatory authorities**. Without such a veto right, the Commission sees no warranty for consistent regulatory measures throughout the EU. In expanding the veto right, the Commission would be able to block national regulatory measures and prevent Member States from taking different regulatory measures for comparable market situations. The Commission is of the opinion that this impedes the functioning of the Single Market.

There are six reasons why this kind of veto right for the Commission is not appropriate.

Firstly, the veto right **is not necessary**. If the Commission is of the opinion that the regulatory measure of a national regulatory authority impedes the Single Market and fails to fulfil the results of the preceding market analysis, it is free to take action against the corresponding Member State for failing to fulfil an obligation under the ECT according to Articles 226 - 228.

Secondly, the concentration of decision-making competence in the hands of the Commission **does not comply with the subsidiarity principle**. The national regulatory authorities, whose independence is stipulated in Article 3 of the framework directive, have extensive knowledge about the special conditions of their national telecommunications markets and are better able than the Commission to react with (differing) regulatory measures to the results of the market analysis.

Thirdly, there is a risk that an extended veto right for the Commission **would result in a scale of regulation which is not justifiable in terms of an ordo-liberal regulatory policy**. In its proposals to review the regulatory framework, the Commission has shown little interest in proposing a clear, substantiated concept for reviewing the need for regulation. Therefore it cannot be ruled out that in order to expand its own influence, the Commission tends to use the extension of its veto rights to prevent any cutback in meanwhile superfluous regulation.

Fourthly, a **harmonisation of national regulatory measures throughout the EU**, which can be expected as a result of such veto for the Commission, **is not desirable**. The differing circumstances on the national telecommunications markets demand different measures. In terms of an ordo-liberal regulatory policy and in order to avoid any distortion on the Single Market, it is merely necessary to ensure that the measures are taken according to the same rules and principles, and not that all measures of the Member States are identical.

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<sup>41</sup> See: Joint Statement by Vivianne Reding, EU Telecom and Media Commissioner and Robert Viola, Chairman of the European Regulators Group (ERG) after their meeting on 27 February 2007 on the forthcoming reform of the EU's Regulatory Framework for electronic communications, MEMO/07/87.

Fifthly, it is in fact the different measures implemented by the national regulatory authorities which give rise to corresponding **competition** for the best regulation concept. This dynamic will be lost if the Commission vetoes the adoption of measures that do not comply with its concept.

Sixthly, an expansion of the Commission's veto rights contradicts its efforts to simplify the Article 7 procedure. Repeated use of the veto right would result in **protracted Article 7 procedures**, because the margin of discretion for the national regulatory authorities would be essentially eliminated.

## 2.4 Suspensive effect

While the Commission's intention to prevent abuse of the objection procedure is to be welcomed, the concrete form this should take gives rise to considerable reservations.

**The Commission** deplores the fact that the national courts regularly make use of the possibility of ordering a suspensive effect during appeals against a sector-specific regulation. It **suggests that it should only be possible to order the suspensive effect when there is a risk of irreparable damage to the petitioner**, and that a corresponding ruling should be included in the framework directive.

**But such a provision would be illegal**, notwithstanding the question as to what sort of regulation order is being contested.

If the regulation is an order serving solely the enforcement of national law, then the Commission's proposal violates the principle of institutional and procedural autonomy of the Member States. The European Court of Justice has ascertained that "in the absence of Community rules governing a matter, it is for the domestic legal system of each Member State to designate the courts and tribunals having jurisdiction and to lay down the detailed procedural rules governing actions for safeguarding rights which individuals derive from the direct effect of Community law"<sup>42</sup>. If the procedural rules of the domestic legal system are excepted from an EU regulation even in cases of protection for the petitioner from the direct effect of Community law, then nothing else can apply to protection in purely domestic procedures.

It is similar in the case of orders serving to enforce Community law. On the one hand, it is in line with the consistent jurisdiction of the European Court of Justice that in this case the principle of institutional and procedural autonomy is subject to certain restrictions and "must not [...] render virtually impossible or excessively difficult the exercise of rights conferred by the Community"<sup>43</sup>. As prerequisite for suspending the execution of a national administrative instrument based on a Community Regulation, the Court of Justice also names among others the requirement stipulated by the Commission that the petitioner must be threatened with severe irreparable damage.<sup>44</sup> At the same time, it would go too far to derive a right for the EU to legislate in this area from the judicially coloured restriction on the principle of institutional and procedural autonomy. Furthermore, a corresponding provision would violate the protocol on application of the principles of subsidiarity and proportionality. Accordingly, "Community measures should leave as much scope for national decision as possible, consistent with securing the aim of the measure and observing the requirements of the Treaty. While respecting Community law, care should be taken to respect well established national arrangements and the organisation and working of Member States' legal systems."<sup>45</sup> As

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<sup>42</sup> ECJ, Case C-312/93, Grounds 12.

<sup>43</sup> ECJ, Case C-312/93, Grounds 12.

<sup>44</sup> ECJ, related Cases C-143/88 and C-92/89, Grounds 33.

<sup>45</sup> Protocol on the application of the principles of subsidiarity and proportionality, No. 7 of the protocol.

the national courts are bound to abide by the verdicts of the European Court of Justice, there is accordingly no need for an explicit stipulation of this prerequisite within the regulatory framework. It is therefore not necessary to include a corresponding provision in a directive which would violate the principle of proportionality.

### 3. Structural and functional separation of infrastructure and services

It is to be welcomed that in its impact assessment of its communication, the Commission rejects property-related (structural) separation as unsuitable for the telecommunications sector.

A mandatory property-related separation of infrastructure and services would be a severe intervention in the property rights of vertically integrated companies. If such intervention were prerequisite for permitting permanent competition, it would result in a conflict in objectives in terms of an *ordo-liberal* regulatory policy. In such case, it would be necessary to weigh up which objective were more serious: protecting the **property rights** of the infrastructure owners or **bringing about competition** specifically through this structural separation to the benefit of the economy. This debate would involve not only economic aspects, because the separation of infrastructure and services would significantly affect the constitutionally protected area of property.

There are also other reasons for having significant reservations against using structural separation in the review of the telecommunications regulatory framework.

Firstly, the **benefit of structural separation is disputed**. Even the OECD expresses doubts as to whether the benefits of structural separation in the "local loop" exceed the costs involved.<sup>46</sup>

Secondly, structural separation would constitute a permanent, **irreversible regulatory measure** which is incompatible **with the provisional nature of the sector-specific ex-ante regulation** of the telecommunications sector. According to the Commission, "*Once a competitive market is effectively established, many of these provisions should no longer be necessary and it would therefore be sufficient to rely mainly on the application of the competition rules of the Treaty.*"<sup>47</sup> However on achieving such a market, it would not be possible to reverse any property-related separation between infrastructure and services.

Thirdly, **competition can be achieved even without** this profound intervention **in property rights**. The existing Access Directive stipulates that providers with significant market power can be forced among others to "give third parties access to specified network components and/or facilities, including unbundled access to the local loop".<sup>48</sup>

The Access Directive thus permits what competition law could also achieve in the absence of such a directive, at least when it comes to the essential facilities: all final customers of the providers are accessible at a cost-oriented price. Competition can thus be brought about without any profound, irreversible intervention in property rights, both **by an Access Directive and also by competition law**.

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<sup>46</sup> "The Benefits and costs of Structural Separation of the Local Loop", OECD Working Party on Telecommunication and Information Services Policies, DSTI/ICCP/TISP(2002)13/FINAL, 3 November 2007.

<sup>47</sup> See discussion on page 2.

<sup>48</sup> Directive 2002/19/EC of the European Parliament and of the Council on access to, and interconnection of, electronic communications networks and associated facilities (Access Directive), Article 12 in conjunction with Article 8.

Following the case law of the European Court of Justice<sup>49</sup> and also in the opinion of the Commission<sup>50</sup>, prerequisites for network access enforced by competition law include the fact that

- access to the essential facilities, in particularly the local loop, is indispensable for the activity of the company desiring access,
- refusing access is capable of preventing competition on the affected market,
- no alternative is used or can be created from the business management point of view,
- refusing access is not justified in objective terms.

An Access Directive and the competition law thus provide two possibilities, both of which are suitable for achieving the objective and both of which constitute a less profound intervention in property rights than a structural separation of network and operation.

For these three reasons, a **property-rights related separation** of infrastructure and services has to be considered as an **inappropriate and disproportional intervention**. **The Commission's rejection** of this measure **is therefore to be welcomed**.

However, the **functional separation** proposed by Commissioner Reding is **disproportional** as well.

There is already a comprehensive regulatory framework regulating the access of third-party providers to the network of an operator with significant market power. Both the Access Directive 2002/19/EC and competition law facilitate such access.

Before reverting to the more severe intervention of functional separation, firstly it must be verified that less drastic measures based on the Access Directive and competition law are not sufficient to bring about competition. Particularly in Germany, competition on the telecommunications market has intensified significantly in recent years. The total number of telephone connections offered by competitors of Deutsche Telekom AG has increased by a factor of 2.5 since 2004. Meanwhile more than half the German population has a choice between several connection providers.<sup>51</sup>

The prerequisites for functional separation and the associated severe intervention are therefore not fulfilled in Germany. The added value of the functional separation proposed by Commissioner Reding is not apparent.

Consideration must also be given to the fact that firstly, functional separation causes considerable operational costs. Affected operators with significant market power would be obliged to restructure their internal organisation at high expense and at their own costs. From an economic point of view, it should be verified first of all, that the costs of these measures are compensated by resulting benefits.

Secondly, it is to be expected that functional separation would consolidate itself. Functional separation harbours the danger of depriving competitors of the incentive to invest in establishing their own networks.

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<sup>49</sup> ECJ, Case C-7/97, Grounds 38 et seq. (with further evidence).

<sup>50</sup> Notice on the Application of Competition Rules to Access Agreements in the Telecommunications Sector, OJ C265 dated 22.8.1998 C265/2C et seq.

<sup>51</sup> Bundesnetzagentur, Annual Report 2006, p. 61.

As a result, bringing about infrastructure competition and thus the possibility of reversing functional separation would therefore be postponed to the far distant future.

The functional separation proposed by Commissioner Reding therefore does not contribute to the objective of the EU regulatory framework of creating a competition market by means of a merely provisional regulation. In the end, it would result in permanent regulation and must therefore be rejected.

## CONCLUSION

There are major reservations against the proposals made by the Commission for reviewing the EU regulatory framework for electronic telecommunication.

On the one hand, the Commission's objective of achieving lasting competition on the telecommunications markets must be welcomed. However, on the other hand the proposed changes in the regulatory framework do not indicate that the Commission is aiming at a scope of regulation which is necessary from the point of view of an ordo-liberal regulatory policy. It appears to have been forgotten that sector-specific ex-ante regulation was intended precisely to bring about competition and should become superfluous on reaching this stage.

The three-criteria test developed by the Commission will also in the future decide which markets will be subject to sector-specific ex-ante regulation. In its current application, the test does not guarantee that regulation is limited to monopolistic bottlenecks. In terms of regulatory policy, a stricter orientation of this test to the theory of monopolistic bottlenecks is indispensable, together with mandatory application of the test to national markets, instead of to an average European market.

The institutional alterations proposed by the Commission are not suitable for limiting regulation to the necessary minimum extent. In fact, the alterations in procedure proposed by the Commission appear above all to aim at expanding the Commission's own regulatory competences. In particular the proposed right by the Commission to veto regulatory measures by the national regulatory authorities would result in such centralisation and harmonisation of the regulations. The reasons brought forth by the Commission for such a veto right are not convincing.

The Commission rightly refuses structural separation between infrastructure and service on the telecommunications sector. This kind of separation and also functional separation are disproportional: the existing Access Directive and competition law are suitable for guaranteeing competition with less profound intervention by the legislator.