

ETNO Reflection Document on Market Analysis Procedures in Accession Countries^A

Executive Summary

After first liberalisation efforts in recent years the new member states and pre-accession countries are now striving to cope with the diverse challenges resulting from the implementation of the New Regulatory Framework for electronic communications (NRF) into their respective national laws. The NRF was designed with the developed telecommunications markets in 15 existing member states in mind. As these markets have many years of experience with the liberalised market environment, it is now even more important that the significant economic and market differences between accession countries and EU member states are taken into account during the Market Analysis Procedure (MAP) and in the promotion of broadband and Information Society development. This paper focuses on possible approaches for these issues in Accession Countries (ACs).

This position paper is fully coherent with positions already expressed by ETNO concerning the NRF and its implementation, in particular its recent position on the ERG paper on Remedies. ETNO continues to fully subscribe to the concept of harmonisation throughout Europe and to a technology neutral regulation, and thus that the NRF should be applied equally in AC and EU15 countries. In principle, the current framework allows for adequate flexibility to deal with different market characteristics in new and old member states. However the association finds it important that the Commission, the ERG and the professional community are made aware of the particularities of the implementation of the NRF under specific market realities that prevail in AC countries.

Accession country market particularities require an in-depth analysis of all markets, whereby transparency and reasonable consultation deadlines should be ensured during the whole market analysis process. To ensure proper application of MAP in ACs, in the course of identifying markets where ex-ante regulation is necessary, AC NRAs should be encouraged to draw appropriate and proportionate conclusions from the respective market particularities and trends. In general these will be different from corresponding developments in WE. NRAs should thus refrain from copying WE MAP patterns and decisions, i.e. remedies appropriate for WE

countries. Legally AC NRAs should concentrate on the 18 markets of the EU Recommendation. However, geographical segmentation might also be considered if markets can be segmented due to heterogeneous competition conditions.

The only solution therefore for accession countries – leading to sustainable competition – is the application of tailor-made, appropriate remedies and the acceptance of the fact that the outcome/result in AC markets might be different from WE telecom markets as neither a simple transposition of WE remedies nor “artificial” remedies designed to shape the current WE market structures will be sufficient.

Therefore, regulatory tools for wholesale markets which could lead to below-cost wholesale prices have to be avoided. For example, remedies to artificially reduce costs by altering costing models or neglecting necessary cost elements cannot be applied.

With regard to price regulation in retail markets due to mobile substitution/competition, AC fixed operators are not in a position to abuse their market position, even in the longer term. Retail price regulation should therefore be eased.

To eliminate the digital divide between ACs and WE member states, besides general tools such as encouraging the use of Internet by promoting communications and developing attractive content, there is a strong need for funding broadband development in ACs especially in areas where Internet and broadband provision is not economically feasible. In this respect, in addition to governments’ actions (like tax allowances and direct funding of projects) utilisation of structural funds through National Development Plans could play an important role. Unfortunately, such funding does not provide sufficient resources. Therefore, as far as the normal development of a competitive market is not affected, Cohesion Funds should be expanded to support broadband infrastructure developments as these investments – similarly to environmental and transportation investments – serve the interests of the whole accession region. In addition, regional projects can be established to promote further broadband development from a regional level perspective.

I. Introduction and scope ^{1, 2}

There are significant differences in the economic and market situation between accession countries and the existing EU member states which should be taken into account during the market analysis procedures in accession countries.

The EU Commission is already aware of these differences as stated by EU Commissioner Liikanen in a letter to the CEOs of TPSA, Matáv and Slovak Telecom dated 27 February 2004. In particular, the Commissioner refers to network penetration, the cost of infrastructure and the provision of universal services. A recent data gathering among ETNO AC members reconfirmed these differences, providing data from an extended circle of ACs and covering a longer period (1998 - 2003) in comparison with the data already presented in the Andersen Business Consulting CEE White Paper^B.

Though the acknowledgement of such market driven differences is crucial, it is also compulsory to point out the consequences for the regulation as well. Therefore Commissioner Liikanen's statement that the New EU Regulatory Framework is now much more flexible for taking due account of the differences between the markets and economic situations of member states is of major importance for the application of the market analysis procedure by AC NRAs. It is crucial that the EU Commission shall closely monitor the situation in accession countries with regard to a proper application of the EU NRF, the adaptability of the framework for different market situations and structures as well as the NRAs' obligations to encourage efficient investment in infrastructure, and the promotion of competition and innovation. The Commission should also ensure that AC NRAs' decisions fully comply with the objectives of Art. 8 of the Framework Directive (FWD), and that decisions on market analysis and remedies are in line with the procedures set forth in Art. 6 and 7 of the FWD.

The current paper is focussing on relevant issues for the concrete application of the Market Analysis Procedure (MAP) and the challenge for broadband and Information Society development in accession countries.

¹ TDC, Telekom Austria, Telenor and VIPnet disagree with the paper as they find that some of the issues raised in this may very well be common to some other Member States. Furthermore, the principles advocated throughout the paper are also applicable to current EU Member States. In some parts, the document seems to split Europe into two blocs, WE and AC. The document also seems to take the position that the regulation applied in WE may be valid for WE, but that it should not be applicable to AC. They think that this sort of approach should be avoided. In their view, some of the regulatory mistakes raised, such as artificial cost models, wholesale prices below costs, investment ladder, etc., should not apply in WE either.

² BT does not support this paper as it believes the same regulatory approach, involving proper market analyses at the requisite level of geographical and customer segmentation should be adopted in all Member States. BT is concerned that the paper inappropriately anticipates the outcome of some of these market analyses.

The concrete application of Market Analysis Procedures

While AC operators always unsuccessfully emphasised towards their governments the necessity to raise these differences during the accession negotiations with the EU and reflect them adequately through the application of derogation periods, in the current situation the application of the built-in flexibility of the NRF and the market analysis procedure is even more important. From the 3 steps of the MAP especially market definition and the selection of remedies with regard to the proportionality principle and the role of investment have to reflect the AC market differences in comparison with WE. With regard to SMP designation EU competition law principles as laid down in the Guidelines based on ECJ jurisdiction have to be applied.

A mere copying of WE NRAs' market analysis patterns or notifications and those related EU-COM decisions by AC NRAs is thus not acceptable. Any AC market analysis requires an in-depth assessment of the specific national market situation – in many cases similar to the situation in other accession countries – by the respective NRA and a transparent public consultation procedure. Although a delay of the MAP after the implementation of the EU NRF into national law is not desirable, it has to be stressed that markets and operators should not suffer or even be harmed from a market analysis procedure which lacks proper rigour. Thus rigorous application of the MAP is paramount and transparency together with reasonable consultation deadlines in relation to decisions on market analysis and remedies should be ensured. In this respect the way some ACs (e.g. Malta and Hungary) have consulted, or are consulting, stakeholders on the draft laws transposing the NRF is an ongoing matter of concern. In Hungary, for example, industry is given very short deadlines for commenting (often not more than 3-4 days) to draft legislation in progress. It should be ensured that such unacceptable conditions are not repeated during the MAP, but that industry opinion is properly taken into account and AC NRAs consult adequately (in line with Art 6 and 7 of the FWD) before deciding.

To ensure that national particularities are properly taken into account, the outcome of the already existing WE market analysis procedures should be critically analysed by AC NRAs and an appropriate assessment is required to determine whether the assumptions and results fit to the AC market environment. For AC NRAs sufficient time and qualified resources (manpower) have to be made available. This will allow them to fully understand AC market dynamics, to conduct a proper market analysis, and to apply proportionate and appropriate remedies while identifying AC-market-compliant solutions that can be justified vis-à-vis the EU Commission, other NRAs and the ERG.

The role of NRAs, EU-COM and ERG/IRG in Market Analysis Procedures

Although the market analysis procedure is primarily an analysis undertaken by an NRA focussing on a respective national market, NRAs also have to be supported by the EU Commission. We assume the EU Commission expects that NRAs take due account of their market particularities. Upcoming pre-notification meetings of NRAs with the EU-Commission should be used by the NRAs to discuss and assess the flexibility granted by the NRF. NRAs will have to explain and justify any market definitions, SMP and remedy assessments different from those in the notifications of WE NRAs or already existing EU Commission comments or decisions.

In addition to the bilateral interaction between EU Commission and AC NRAs for a justified consideration of AC market particularities during market analysis, it is also necessary to address this issue at ERG/IRG level. Otherwise there is a risk that AC interests are not taken into account adequately, e.g. with regard to the ERG Remedies Paper^C. The final version of the Remedies Paper does not reflect AC market particularities and their possible consequences for imposing remedies on AC markets.^D

Especially with regard to the critical situation of fixed network investments in ACs where revenues and traffic are stagnating or even decreasing, it is crucial to consider the AC industry/operator perspective. ETNO would therefore highly appreciate the possibility to discuss the issues handled in this position paper with the EU Commission and would like to extend the discussion to AC NRAs and towards ERG/IRG.

II. Market Analysis Procedure in Accession Countries

Market definition

The EU Commission set the frame for handling market definition in its "Recommendation on relevant product and service markets^E" by identifying 18 markets for which competition law remedies may be insufficient to effectively redress possible market failures and thus ex-ante regulation may be needed. The Commission assumes that only those 18 markets justify ex-ante regulation based on the 3 criteria test (high and non-transitory entry barriers, markets which do not tend towards effective competition and insufficiency of general competition law).

AC NRAs should thus concentrate on the analysis of those 18 markets. However, they are expected to assess and profoundly analyse national AC particularities. For example, cable operators play a significant role in the

provision of broadband Internet access in some ACs (even a leading role in certain countries) and in some WE countries, like Belgium, the Netherlands and Denmark. Thus in line with the principle of technological neutrality the analysis of market 12 of the Recommendation – Wholesale Broadband Access – cannot be limited to bit stream access only, but also has to assess the possibility of substitution by other technologies – i.e. cable, WLAN, RLL – for the transmission of broadband data.

Besides the relevant product and service markets, geographical market segmentation may play an important role and cannot be disregarded – particularly if markets can be segmented due to heterogeneity of competition conditions according to EU competition law principles. This is not only the case for countries like Hungary, which had different concession areas with local telecom operators (LTOs) that had exclusive rights before market liberalisation. If a former concession company in its respective local area still has dominant position, competition conditions between LTO areas of different former concession companies are not homogenous. Thus all LTO areas of different concession companies have to be assessed independently during market analysis. In this respect Hungary cannot be considered as a single market with homogenous competition conditions for all services.

In respect of geographical segmentation, another issue relevant for some AC markets with low density of population in rural areas and population concentrated in few urban areas could be a differentiation according to the level of competition in the different urban and rural areas. Due to attainable economies of scale and scope competition focuses on those segments which could also be differentiated from surrounding areas via the homogeneity of competition conditions.

SMP designation

SMP designation in ACs, as in the 15 Member States, has to follow competition law principles as laid down in the Commission Guidelines according to the interpretation of the European Court of Justice.

In general as voice telephony goes mobile faster in ACs than in WE – starting from a lower level of fixed network penetration and also due to the ongoing mobile substitution –, competitive and demand side driven market conditions are limiting fixed operators to increase retail prices both in the short and in the long run. Thus there is no possibility for AC fixed line operators to abuse their position by behaving independently of competitors or consumers and raising prices without a significant loss of sales and revenues from traffic and access services. Customers in ACs, who are very sensitive to any price increases due to their comparatively low level of disposable income, easily renounce fixed (access and traffic) services in favour of mobile services. This will especially be the case as long as Internet in general does not take up a significant role in accession countries and thereby prevent consumers from giving up their fixed access.

III. Critical aspects for application of remedies in ACs

General points

Due to considerable differences between accession countries and existing member states re economic and market situations, e.g. network penetration and cost of infrastructure, the *simple transposition* – thus a mere copying - of remedies applied by NRAs for Western European markets may not lead to long-term and sustainable competition in accession countries but there is rather a threat that this will have negative effects, e.g. on investment. Of course, if a remedy applied in WE is appropriate and proportionate for the market situation of ACs, it should be applied but it shall also undergo critical examination and be subject to in-depth market analysis.

Another approach which should also be avoided is *the targeting of a certain market/competitive structure found in Western European markets and considering it to be appropriate for AC markets* - assuming that it will similarly lead to sustainable competition in the AC region. The focus should rather be on the clearing of market distortions.

There is a great danger, that in order to achieve such market structures „artificial target designed“ remedies are applied, i.e. remedies which are not appropriate or proportionate to the specific situation, but are created to achieve an artificial target such as a certain market structure. Such artificial tool can be for example the regulation of wholesale access costs oriented at a level where market entry is expected, but disregarding the appropriate underlying cost situation of the obliged operator. It is clear that this will not lead to sustainable competition, it will not fit the overall AC investment situation and distort the fundamentals of the market, increasing the risk of investments and market entrance in the long-term.

Due to the present critical situation for investment in the fixed network in ACs, an approach to promote service based competition as the first step for sustainable infrastructure based competition in the long term does not seem to fit the ACs market development. Contrary to WE, where mobile penetration only started to pick up after fixed markets had been fully developed and liberalised, and where mobile services are considered as complementing rather than substituting fixed voice services, mobile penetration in accession countries at the time of liberalisation was already at the level of fixed penetration. This market trend and the underlying customer behaviour are still driving AC markets today, which is clearly reflected in the significant shift of voice minutes from fixed to mobile services.

Thus it is a fact that the mobile success story based on a non-interventionist regulatory approach has an impact on fixed business. However the mobiles did not boom as a result of barriers to competition in fixed markets. The uncertain prospects of the development of the fixed markets in ACs lead to the limitation of investments and competition potential.

As a consequence, the only solution for AC markets is to accept the underlying market drivers in ACs, to apply *appropriate remedies* in line with the market environment and to accept the fact that the outcome in AC markets might be different from WE telecom markets, reflecting the preferences of the customers, the potentials for competition, the economics of AC markets, and the cost structure and investment incentives for the operators.

Retail regulation

Since ACs are in general characterised by lower fixed penetration, stagnating or even decreasing fixed traffic, smaller telecommunications markets and lower connection density with far lower GDP per capita, operators cannot exploit economies of scale in ACs in the same way as their Western European counterparts. Therefore unit costs for fixed services in ACs tend to be higher than of those in the existing EU Member States.

While unit costs tend to be higher, retail prices are on the one hand much closer to prices in old member states of the EU allowing for lower margins and thus for less space for competition from a mere price perspective.

Fixed operators, on the other hand are still facing access deficit problems. In the short term there are only limited or in some cases no further possibilities for rebalancing as price increases (primarily through the increase of subscription fees) is limited by low demand and ongoing mobile substitution. Obviously, in those countries where such constraints do not exist, tariff rebalancing should be completed without delay.

As stated above, fixed operators are strongly limited in increasing retail prices both in the short and in the long long-term. Therefore the limited or non-existing ability of ACs fixed operators to abuse their market position should also be reflected in any choice of remedies applicable for the retail markets. Regulators should focus on wholesale regulation rather than on retail regulation in line with the general principle of the EU NRF telecom regulation and retail regulation should only be applied as a last resort, i.e. where wholesale regulation has proven insufficient. Therefore transparency and publication of retail prices should be sufficient instead of applying any type of retail price regulation as an adequate remedy for retail markets in ACs. At least price control for retail tariffs in the fixed network should be eased.

On the other hand, providing wide-scale availability and affordability for all customers, results in a strong need for financing universal service provisioning in ACs in order to compensate operators for higher financial burdens which is due to higher unit costs, access deficit and affordability problems. Moreover the applied financing mechanisms should not use tools to artificially reduce the cost of providing universal services (e.g. by not acknowledging certain related costs or overrating the image-value of public payphones) in order to formally reduce financial burdens that operators are facing.

Wholesale regulation

Since AC telecom markets are characterised by the aforementioned generally recognised particularities, a mere copying of Western European remedies or costing models to AC wholesale markets (e.g. IC tariffs with application of WE benchmarks) or applying “artificial” remedies to create an artificially favourable environment for market entry (e.g. by artificially altering cost models or inputs to cost models to achieve lower cost levels) will not be in line with the ACs operators’ actual cost situation as demanded by Art. 13 of the Access Directive. Proven and justifiable costs have to be acknowledged even if they tend to lead to a higher wholesale price level in ACs than in old member states.

Decreasing costs “artificially” by applying tools such as disregarding the relevant WACC (weighted average cost of capital) or prohibiting the accounting of recent investments and neglecting necessary capacity in FDC (fully distributed costs) costing schemes or not applying appropriate and justified mark-ups in line with LRIC (long-run incremental costs) methodology has to be avoided. On the one hand such an approach contradicts price control principles of Art. 13 of the Access Directive, i.e. NRAs shall take into account the investment made by the operator and allow for a reasonable rate of return. On the other hand such artificial tools may lead to wholesale prices below actual costs which will discourage innovation, investment and sustainable competitive development in the end.

Due care must also be taken in case of any retail-minus type price regulation for access services in AC markets as – due to higher unit costs, lower margins and lack of further rebalancing possibilities – this type of regulation may lead to below-cost wholesale prices and even result in economic losses for operators.

In this respect in order to deal with the existing access deficit, the lack of rebalancing possibilities and the threat of below-cost wholesale pricing, it is essential for AC markets that appropriate remedies are imposed to compare wholesale access and traffic services with retail access and traffic services. Thus not only the individual costs of access provision (ULL prices) or traffic services should be compared with the respective retail tariffs for these services. It is rather necessary to compare wholesale access and traffic services jointly with the relevant retail tariffs before applying

any regulatory intervention or remedy focussing on access or a specific traffic service only.

IV. Bridging the gap for the creation of an Information Society in ACs

Need for appropriate regulation

Benefits of using Internet are generally understood and universally supported. eEurope itself states many arguments in its favour. Widespread use of Internet can bring significant positive economic effects, which have been to a large extent achieved in most Western European members of the EU. However, there is still a significant gap in this respect between the old member states and the accession countries, which prevents AC economies from enjoying the above-mentioned benefits. Furthermore, increase of Internet use in ACs would bring along much greater and more visible benefits than in Western Europe where Internet penetration is already comparatively high.

While ACs suffer from a significant Internet backlog compared to WE due to slow Internet take-up and low demand for Internet services (caused by low disposable income, low PC penetration, lack of interest and user skills, and lack of attractive content in national languages), there is still a need for substantial infrastructure investment, particularly with regard to broadband, which is considered to be the basis for the Information Society. Therefore encouraging investment and promoting innovation are even more important in the broadband market than in any other markets, since future development and penetration of broadband Internet - as any emerging market - heavily depend on investments in infrastructure and innovations.

However every investor considers at least two factors, on basis of which they decide on the allocation of their financial resources: risk of investment and the level of expected profit. In general, operators - both incumbents and new entrants - will only invest in a market (especially in the Internet market of the ACs where the market is somewhat complex) if they can earn a reasonable rate of return on their investments and their profitability is not decreased or questioned by regulatory tools.

Therefore it is of major importance to create a transparent environment, in which rules are clearly defined and applied and market specifics are also taken into account - so that investment costs can be recovered by investors. Any inappropriate regulatory intervention may have detrimental impact on the roll out of the service. For this reason broadband should be treated as an emerging market, i.e. - according to the ERG Remedies paper - it „should be allowed to develop according to the normal dynamics of market forces“ and regulated only by „the application of general competition law“. This is vital in accession countries where - due to the above factors - it is extremely difficult to achieve the roll out of broadband services.

As a consequence of the crucial role of broadband and infrastructure investment in the Internet market, considerations regarding wholesale pricing and cost allocation principles should be taken into account even more carefully in broadband and in other emerging markets and NRAs should by all means avoid forcing wholesale prices below costs.

Regulation is not sufficient for closing the gap for less developed regions

In ACs the fixed line telecom infrastructure in major cities typically supports access to broadband Internet as a result of broad-scale business minded developments made over the last 1-2 years. In the majority of these areas broadband Internet is also available via the alternative technology of cable television. On the other hand, telecom and Internet service providers in mid-sized cities face problems related to scale of economies, thus investments are only implemented where investment indicators are adequate.

There are however significant problems in the underdeveloped regions and smaller settlements where the proportion of solvent residential demand and business undertakings does not enable the initiation of investments on a pure business basis. In these regions, primarily due to the geographical location of the settlements (economically insurmountable distances and landscape features) in addition to underlying business reasons, the existing network consists of wireless systems and networks that are less developed, technologically obsolete, mostly analogue with limited digitalisation, and inadequate for broadband services.

On the other hand, Internet can bring the most significant benefits in these regions.

If these regions do not receive support from state and community sources the digital divide between the underdeveloped regions and major cities will further increase, thereby reinforcing the handicap of these regions (businesses in other sectors also do not invest in settlements where the telecom infrastructure does not provide for current market demands).

In this respect, structural funds seem to be appropriate, as their very purpose is to equalise the level of development across the EU.

On the other hand, with respect to the future development of the cohesion policy - taking into account the objectives set forth in Lisbon and the eEurope initiative and in line with the Third Report on Economic and Social Cohesion adopted by the European Commission in February - the activities of the Cohesion Fund aimed at closing up in Europe should be broadened to a new area of infrastructure, i.e. the Information Society infrastructure. These investments, similarly to environmental and transportation investments serve the interests of the "whole" accession region and thereby could contribute to the implementation of projects showing beyond the funding through National Development Plans in this

least developed European region. In addition, regional projects can be established aiming to promote broadband development at a regional level.

However, governments on basis of their broadband and Internet strategies, should also provide financial resources for broadband activity either directly (by financing projects) or indirectly (e.g. by imposing lower taxes or giving tax deductions) or both. In Hungary, for example, tax allowances are granted to customers for purchasing personal IT equipment and for telcos and ISPs in relation to broadband investments. There is also a program for promoting Internet access in public institutions. These examples together with many others (e.g. Estonia) show that such efforts can lead to success not only at national level but also on a regional scale. It is crucial to ensure the establishment of public private partnerships in those areas where pure business oriented private financing would not be sufficient for broadband development.

Other elements influencing broadband/Internet development

Measures to be taken to promote broadband access and broadband services should not only focus on financing but on stimulating the use of Internet by other means as well.

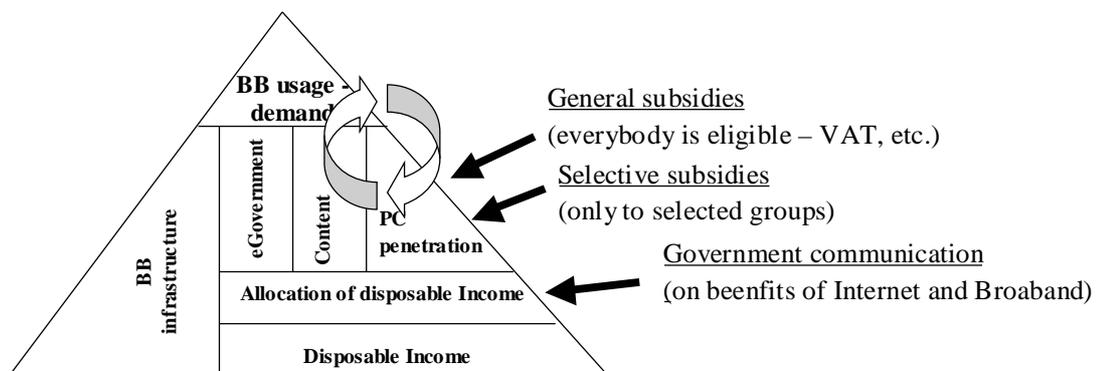


Figure 1: Factors influencing broadband development

For example, as one of the major obstacles to Internet take-up is the low level of disposable income, which is determined by the underlying economic situation and thus cannot be changed in the short term. Subsidies for end-user and/or manufacturers e.g. on PCs could be a solution for encouraging Internet use.

In an effort to promote the widespread use of Internet, there are two other key prerequisites that have to be met: people have to understand the benefits of using the Internet and there has to be sufficient content to motivate users to subscribe to Internet.

Efficient government communications campaigns promoting benefits of using the Internet could substantially change preferences and thus affect

allocation of disposable income of Internet users in favour of Internet and broadband. Again Estonia might serve as an example of how successful such strategy can be.

However, these measures could fail in promoting the use of Internet if sufficient content in national languages is not available. Content is undoubtedly one of the key drivers encouraging the use of Internet, even the purchase of a PC, as users do not merely buy connectivity but use it as a platform for accessing content. Content development however cannot be achieved only by financing specific projects. Governments should take a leading role and create a content basis that would generate widespread use. For example electronic contact with authorities should be introduced for a wide range of services from tax returns to elections. Users could also be motivated to choose electronic over face-to-face contact with the government. Governments could create other applications such as Register of Commercial Subjects, Database of EU information or they may cooperate in creating unified content pages. For example, the Hungarian government has launched a project, besides others, aiming to make available on the Internet all documents about Hungarian history in electronic format.

This content basis will not only motivate potential users to utilise Internet, but as the customer base of Internet users increases, other companies will see their chance in providing these users with their own content applications. Private companies would also benefit by taking part in many of the projects organised by the government as well as in related activities, which would further stimulate content development.

^A When referring to accession countries the situation in EU new member states (like Czech Republic, Cyprus, Estonia, Hungary, Latvia, Malta, Poland, Slovakia and Slovenia) and pre-accession countries (like Bulgaria, Croatia and Romania) are taken into account.

^B „Telecommunications in Central and Eastern Europe: Will there be infrastructure for the information society?“, Andersen Business Consulting, September 2003

^C ERG Common Position on the approach to Appropriate remedies in the new regulatory framework

^D Explanatory Memorandum to the ERG Remedies Paper, p. 9 only states: "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."

^E Commission Recommendation of 11 February 2003 on relevant product and service markets within the electronic communications sector susceptible to ex ante regulation in accordance with the Framework Directive