

Agenda

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Nice to nasty: the changing outlook for European telecoms regulation

The economic environment for the European telecommunications industry has changed considerably since the financial crisis hit, but its regulators appear to be living in the Golden Age of robust industry growth and falling prices for consumers. Richard Feasey, Public Policy Director at Vodafone, asks where European regulation needs to change and suggests options for a new approach to telecommunications regulation that is more suited to the current and future challenges

Europe's leaders are often accused of reacting too slowly to the unfolding sovereign debt crisis, and its institutions are struggling to adapt to fast-changing conditions. Policy-makers remain trapped by their own prejudices or by short-term political considerations which prevent them from taking decisive or strategic action.

This gloomy diagnosis is not confined to macroeconomic or fiscal policy in Europe today; it applies to microeconomic regulation as well. The approach to regulating Europe's telecommunications sector—a sector which needs to perform strongly if the region is to escape from its current economic woes—is a case in point.

The nice period

Much of the regulatory architecture which oversees the telecommunications sector (but also transport, energy and water) was designed during the late 1980s and 1990s. This was a period when Europe was an attractive place for global investors and when a policy of opening up markets attracted firms from the USA and Asia and allowed the creation of home-grown companies such as Vodafone. The sector grew by more than 8% in the late 1990s¹ and mobile markets ticked along with growth rates of 15–25% every year.

Prices for telecommunications services in Europe were still high. A three-minute national fixed call cost €0.65 in 1998 (but had fallen to €0.24 by 2009).² The twin legacies of political ownership and monopoly meant there were large pockets of cross-subsidy between different services and between different groups of consumers. At the heart of this world were the newly created national telecoms regulators—Oftel, ART, AGCOM and the rest—staffed by technical

experts and charged with injecting competition and making sure the resulting benefits were allocated equitably between different groups of consumers.

The biggest challenge for policy-makers during this period was whether to favour a model of 'services competition' or 'infrastructure competition'. This was before Professor Martin Cave invented the concept of the 'ladder of investment', which allowed them to claim support for both at the same time.³ The idea that such apparently conflicting objectives could be neatly reconciled in a positive way was a key feature of this period, and not only in telecoms regulation. This was the period in which the Governor of the Bank of England coined the acronym 'nice' to describe a world of Non-Inflationary Constant Expansion.⁴ In telecoms, it meant that prices could fall sharply year on year without any apparent drag on levels of investment. Much of the investment in infrastructure was already sunk and there were still opportunities to extract large efficiency gains from it. In short, the telecommunications sector seemed a perfect example of the kind of non-inflationary growth which policy-makers were targeting for the broader European economy.

There was some room for doubt, even at this early stage in the experiment:

- third, fourth or fifth entrants into European mobile markets struggled to gain sufficient scale to become profitable, despite the efforts of regulators to support them through 'temporary' asymmetric rate regulation over many years;
- the new fixed network competitors entered by relying on (highly) regulated access to the incumbent's

- copper network but then failed to climb any further up the investment 'ladder'. The incumbent operators largely avoided fixed competition between themselves and remained focused on defending their home markets. Cable networks were largely ignored by the policy-makers during this period (but despite, or perhaps because of, this, they have since emerged as key competitors in the fixed broadband market);
- in 2005, after ten years of almost permanent litigation, the United States abandoned the 'services' model for fixed network competition favoured by the Europeans and embarked on a very different 'duopoly' path instead.

None of these developments was sufficient to prompt a fundamental reappraisal of the European model during the review which was held between 2006 and 2009.⁵

The nasty period

The initial reaction of policy-makers to the financial and economic crises which hit Europe in 2008 was to reaffirm the importance of the telecommunications sector for the broader European economy and establish a new set of targets for it.⁶ No serious attempt was made to ask whether the underlying policy framework was capable of delivering those targets. This was in part because Europe was already midway through the review referred to above, but also because all of the existing regulatory institutions, particularly the national regulators, were by that time heavily invested in the status quo. Not much changed inside telecommunications regulators in 2008, even as the economic storm began to rage outside. Being, by nature, cautious people with a strong attachment to precedent and consistency, telecommunications regulators simply continued much as before.

Inside the industry, doubts about the approach were becoming more acute. The years of steady retail price reductions, squeeze on costs, and commitments to private shareholders meant that industry players had much less financial headroom when the debt markets seized up. The result was that telecommunications markets did not grow at all in 2009,⁷ and the 'nice' period came to an abrupt halt.

Differences between regulators and those they regulate are commonplace and to be expected, but earlier disagreements about the application of rules in a particular case or against a particular firm had been conducted against widespread consensus among almost all players—regulators and firms, incumbents and new entrants alike—about the merits of the overall European approach. We are now seeing more fundamental disagreements emerge on a wide range of issues, with critics claiming that:

- regulators remain preoccupied with driving down consumer prices, despite these being many times lower today than in the 1990s when the framework was conceived. If anything, recent pressures on disposable incomes have made regulators even more focused on prices than before;
- promoting new entry remains an overriding objective for many telecommunications regulators, as it was in the 1990s, even though Europe's diminished growth prospects, maturing markets, lower margins and higher costs of finance make entry increasingly unlikely today;
- pricing rules devised by regulators assume that investments in networks have already been sunk and so can be ignored, or that very large fixed costs, such as the payments for spectrum in recent years, can all be recovered from non-regulated services;
- few regulators seem to fully understand that capital is no longer abundant or cheap, or that Europe is no longer an attractive continent on which to deploy it. If they do, it is not apparent in the decisions they take;
- regulators must undertake regular reviews of markets to safeguard competition before investments have paid back. The uncertainty this creates for the investment climate is rarely recognised, and no proposals have been made for alleviating it;
- the Commission presses for ever-greater harmonisation of policy and of prices just at the moment when the economic outlook among Member States is diverging sharply.

Where to now?

Some of today's industry critics can be dismissed as harking back to the pre-1990 days of unregulated monopoly. But others, myself included, are making what I think is a more subtle case which cannot be so readily dismissed. This critique does not yet amount to a coherent alternative approach to regulation, but it suggests that the approach taken in Europe needs to change in some or all of the following ways:

- much more focus on outputs and market performance and much less on inputs, such as the number of players or market concentration (a legacy of the early liberalisation days). Prices become only one of the outputs with which regulators must concern themselves, while investment, innovation and, in particular, the sustainability of competitors receive much more attention than in the past;⁸
- accept—as the USA has done—that oligopolistic rather than perfect competition is the only way for

markets to generate sufficient returns to fund major new investments in fixed (ie, non-variable) assets. Abandon attempts to support sub-scale firms that are not viable, particularly when these inhibit the capacity of existing firms to invest or grow, or otherwise undermine other objectives;

- experiment with new models of competition, which allow capital to be used more efficiently without sanctioning a return to monopoly. Examples are the proposal for a ‘Netco’ investment model for fixed next-generation access, as proposed by Oxera in a recent paper for Vodafone,⁹ or more aggressive network-sharing arrangements in the mobile sector;
- make structural measures a much more important part of the regulatory toolkit and resist constant tinkering. Invest more in setting up the right incentives and market structure at the outset (as occurs with mobile spectrum allocations) rather than simply assuming that regulation can solve problems later (as occurs in fixed telecommunications markets today);
- recognise that technological neutrality is not an end in itself, particularly if different technology choices have far-reaching implications for competition later;
- welcome, perhaps even encourage, industry co-operation. Recognise that Europe needs to not only safeguard competition between firms in downstream markets, but also create interoperable services of sufficient scale and reach to compete in what are increasingly global markets;
- weigh the temptation of short-term consumer gains much more carefully against longer-term dynamic benefits, which will always be much more elusive. Experiment, as the Commission proposes to do,¹⁰ with pricing rules which embody positive incentives to invest. (This does not mean simply allowing prices to rise, although the possibility that prices may need to rise should not be excluded either.);
- be much more tolerant of cross-subsidy and value-based pricing in *both* retail and wholesale markets. Abandon attempts to normalise margins

across services that face fundamentally different demand conditions.

There are some positive early signs of thinking along these lines from the Commission, but no coherent approach has emerged as yet. European Commission Vice-President for the Digital Agenda, Neelie Kroes, organised a series of CEO telecommunications summits during 2011 to discuss how European regulation was performing and what might be done differently.¹¹ Ideas such as linking copper prices to investment commitments, or proposals to deregulate co-invested networks, are being discussed. The Commission is proposing a new (structural) approach to regulation of international roaming markets.

However, the Commission is still trying to use spectrum auctions to inject new entrants into mobile markets that are contracting. The Commission also holds firm to Digital Agenda targets that are clearly unachievable in today’s environment, and it is still trying to force harmonisation of rates across Member States without regard to fundamental differences in their economic circumstances.

This highlights the institutional as well as the intellectual challenge which Europe faces. The Commission is best placed to build a new approach, but seems to lack the capability to do so in a coherent (or rapid enough) fashion. This leaves a vacuum into which the parliamentary institutions—the European Parliament and national parliaments—are moving quickly. We have seen this, for example, with the European Parliament’s recent actions on spectrum policy,¹² and the Dutch Parliament’s efforts to rewrite net neutrality rules.¹³ Neither case suggests this is the right way to go.

Instead of parliamentary politics, we face the altogether more difficult task of finding a new approach to telecommunications regulation which will allow a better balance to be struck between short-term gains for hard-pressed consumers and long-term objectives of European growth. Before 2007, most telecommunications policy-makers could pretend that such trade-offs did not have to be made. Now we will all have to adjust to a new, nastier, reality.

Richard Feasey

¹ European Commission (1998), 'Communication from the Commission to the Council, the European Parliament, the Economic and Social Committee and the Committee of the Regions: Third Report on the Implementation of the Telecommunications Regulatory Package', COM(1998) 80 final, February 18th, p. 1.

² European Commission (2010), 'Corrigendum to COM(2010) 253 final of May 25th 2010. Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions: Progress Report on the Single European Electronic Communications Market 2009 (15th Report), SEC102(630)', COM(2010) 253, figure 8.

³ See, for example, Cave, M. (2006), 'Encouraging Infrastructure Competition via the Ladder of Investment', *Telecommunications Policy*, April/May, pp. 223–37.

⁴ Speech given by Mervyn King, Governor of the Bank of England, East Midlands Development Agency/Bank of England Dinner, Leicester, October 14th 2003, available at <http://www.bankofengland.co.uk/publications/speeches/2003/speech204.pdf>.

⁵ Instead, policy-makers engaged in the age-old sport of arguing about the balance of power between national and European institutions, an argument which eventually resulted in the creation of BEREC (Body of European Regulators of Electronic Communications).

⁶ See European Commission, 'Digital Agenda for Europe', available at http://ec.europa.eu/information_society/digital-agenda/index_en.htm.

⁷ See European Commission (2010), op. cit., table 1.

⁸ For an interesting discussion of these issues in the US context, see Faulhaber, G.R., Hahn, R.W. and Singer, H.J. (2011), 'Assessing Competition in US Wireless Markets: Review of the FCC's Competition Reports'.

⁹ Oxera (2011), 'How a Co-investment Model Could Boost Investments in NGA Networks: Feasibility and Implementation of a Co-investment Model', prepared for Vodafone, November, available at www.oxera.com.

¹⁰ European Commission (2011), 'Questionnaire for the Public Consultation on Costing Methodologies for Key Wholesale Access Prices in Electronic Communications', October 3rd.

¹¹ See European Commission (2011), 'Digital Agenda: Second CEO Roundtable on Broadband Investment to Sustain Internet Growth', press release, MEMO/11/508, July 13th, available at http://ec.europa.eu/information_society/newsroom/cf/itemdetail.cfm?item_id=7211.

¹² The Parliament secured additional powers of oversight over spectrum policy in the 2006–09 review of the EC framework, most recently evident in the debate over the adoption of a Radio Spectrum Policy Programme for Europe. See European Parliament (2011), 'Radio Spectrum: MEPs Reach Deal with Council Presidency', press release, October 28th.

¹³ Government of the Netherlands (2011), 'Free Internet Laid Down in Telecommunications Act', press release, June 29th.

If you have any questions regarding the issues raised in this article, please contact the editor, Dr Gunnar Niels: tel +44 (0) 1865 253 000 or email g_niels@oxera.com

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