

## Annex 2

# Legal and Regulatory Framework

## Introduction

A2.1 This Annex sets out the relevant main provisions of the legal and regulatory framework that applies to issues considered in this Explanatory Statement. In particular, the following is covered below:

- generally about the framework under the EC Communications Directives;
- the implementing UK legislation, the Communications Act 2003;
- the procedures and the three stages for market reviews;
- the reasons why *ex ante* regulation is needed as opposed to relying on competition law remedies;
- Ofcom's statutory Notifications of its decisions;
- Impact Assessments; and
- the key features and legal basis of the charge control regime.

A2.2 Sections 3 to 6 of this Explanatory Statement deal, in effect, with the substantive application of those main provisions to Ofcom's considerations set out in this document.

A2.3 There is a key distinction to be drawn between Ofcom's treatment of the five different markets considered in this document. Two of those markets (inter-tandem conveyance and transit, and local-tandem conveyance and transit) are defined and analysed in the same depth as previous market reviews (see Section 3). For the other three markets (call origination, single transit, call termination), Ofcom is satisfied that there has not been a material change to those markets that would justify more extensive analysis in this document (see Annex 5).

## The Framework under the EC Communications Directives

A2.4 A new regulatory framework for electronic communications networks ("ECN") and electronic communications services ("ECS"), associated facilities and associated services entered into force on 25 July 2003. The framework is designed to create harmonised regulation across the European Community ("EC") and is aimed at reducing entry barriers and fostering prospects for effective competition to the benefit of consumers.

A2.5 The new regulatory framework adopted by the European parliament and the Council in 2002 is established by the following five EC Communications Directives:

- Directive 2002/21/EC on a common regulatory framework for electronic communications networks and services (the "Framework Directive");

- Directive 2002/19/EC on access to, and interconnection of, electronic communications networks and associated facilities (the “Access and Interconnection Directive”);
- Directive 2002/20/EC on the authorisation of electronic communications networks and services (the “Authorisation Directive”);
- Directive 2002/22/EC on universal service and users' rights relating to electronic communications networks and services , (the “Universal Service Directive”); and
- Directive 2002/58/EC concerning the processing of personal data and the protection of privacy in the electronic communications sector (the “Privacy Directive”).

A2.6 The Framework Directive provides the overall structure for the new regulatory regime and sets out fundamental rules and objectives which read across all five Directives.

A2.7 Article 8 of the Framework Directive sets out three key policy objectives which have been taken into account in the preparation of this document, namely promotion of competition, development of the internal market and the promotion of the interests of the citizens of the European Union.

A2.8 The Access and Interconnection Directive sets out the terms on which providers may access each others’ networks and services with a view to providing publicly available electronic communications services.

A2.9 The Authorisation Directive establishes a new system whereby any person will be generally authorised to provide electronic communications services and/or networks without prior approval. Authorisation systems, such as individual or class licences, involving explicit decisions or administrative acts by a national regulatory authority (“NRA”), such as Ofcom, permitted under the previous EC Directives adopted in 1997 are now prohibited. That said, an NRA may impose on ECN and ECS providers specific obligations permitted under the EC Communications Directives, such as obligations on operators designated as having significant market power (“SMP”) specified in the Access and Interconnection Directive.

A2.10 The Universal Service Directive defines a basic set of services that must be provided to end-users.

A2.11 The Privacy Directive establishes users’ rights with regard to the privacy of their communications.

### **The Communications Act 2003**

A2.12 The EC Communications Directives (apart from the Privacy Directive, which was implemented by regulations that came into force on 11 December 2003) were implemented in the UK by the Communications Act 2003 (the “2003 Act”) with effect from (and including) 25 July 2003.

A2.13 In particular, Part 2 of the 2003 Act sets out the majority of that Act’s provisions that implement the EC Communications Directives. Sections 32, 45-50, and 78-90 of that Part are of particular importance. In addition, Ofcom is

required to act in accordance with its general and specific duties in sections 3 and 4 of the 2003 Act, respectively.

A2.14 Under section 3, Ofcom must, in carrying out its functions, further the interests of citizens in relation to communications matters and the interests of consumers in relevant markets, where appropriate by promoting competition. As to the latter, Ofcom must have regard, in particular, to the interests of those consumers in respect of choice, price, quality of service and value for money. This corresponds to the policy objective in Article 8(2) of the Framework Directive where competition shall be promoted by *inter alia* ensuring that users (including disabled users) derive maximum benefit in terms of choice, price and quality.

A2.15 The three key policy objectives under that Article 8 have been set out above. NRAs must take all reasonable measures which are aimed at achieving them. This has been implemented in section 4 of the 2003 Act by requiring that Ofcom acts in accordance with the six Community requirements set out in this section. Where it appears to Ofcom that its general duties conflict with its section 4 duties, priority must be given to the latter.

A2.16 From 25 July 2003 until 29 December 2003, the Director General of Telecommunications and his office, the Office of Telecommunications (“Ofotel”) carried out the functions and responsibilities under the 2003 Act relating to the EC Communications Directives. On 29 December 2003, Ofcom took over those functions and responsibilities, and it assumed the powers of the five former regulators it has replaced, including Ofotel.

## **The Market Reviews**

A2.17 The EC Communications Directives require NRAs to carry out reviews of competition in communications markets to ensure that regulation remains appropriate and proportionate in the light of changing market conditions.

A2.18 The markets reviewed in this Explanatory Statement were first reviewed in 2003 by Ofotel (see further below as to the current market definitions).

A2.19 Each market review has three stages, namely:

- definition of the relevant market or markets;
- assessment of competition in each market, in particular whether any undertakings have SMP in a given market; and
- assessment of appropriate regulatory obligations where there has been a finding of SMP.

A2.20 These three stages will be considered, in turn, below. But more detailed requirements and guidance concerning the conduct of market reviews are provided in the EU Communications Directives, the 2003 Act and in additional documents issued by the European Commission. As required by the new regime, in conducting this review, Ofcom have taken the utmost account of the two European Commission documents discussed below.

## Market Definition Stage

### *General*

A2.21 The first market review stage concerns the identification of a services market (i.e. market definition). Section 79(1) of the 2003 Act provides that, before a market power determination may be considered, Ofcom must identify the market which is, in its opinion, the one which, in the circumstances of the United Kingdom, is the market in relation to which it is appropriate to consider making such a determination and to analyse that market. The procedure for market definitions (known as 'services market identifications' under the 2003 Act) is set out mainly in Article 15 of the Framework Directive and sections 78 to 86 of the 2003 Act.

A2.22 Article 15(3) of the Framework Directive requires that NRAs shall, taking the utmost account of two documents published by the European Commission, define the relevant markets *appropriate to national circumstances*, in particular relevant geographic markets within their territory, in accordance with the principles of competition law. These two documents will be considered in turn.

### *The Recommendation on relevant product and service markets*

A2.23 The European Commission has identified in its first recommendation<sup>36</sup> on relevant product and service markets, adopted on 11 February 2003 (the "Recommendation") in accordance with Article 15(1) of the Framework Directive, a set of product and service markets within the electronic communications sector, in which *ex ante* regulation may be warranted.

A2.24 The Recommendation seeks to promote harmonisation across the EC by ensuring that the same markets are subject to a market analysis in all the Member States.

A2.25 However, as the above-mentioned Article 15(3) makes it clear, NRAs are able to regulate markets that differ from those identified in the Recommendation where this is justified by national circumstances and where the Commission does not raise any objections under Article 7(4) of the Framework Directive. Accordingly, NRAs are to define relevant markets appropriate to national circumstances, provided that they take due account of the markets listed in the Recommendation. This obligation has been imposed on Ofcom under section 79(2) of the 2003 Act.

A2.26 According to Article 15(1) of the Framework Directive, the European Commission shall regularly review its Recommendation. Before adopting a new Recommendation, the European Commission must consult publicly as well as with the NRAs. It stated in its first Recommendation that it would review the need for any update no later than 30 June 2004 on the basis of market developments.

A2.27 However, on 16 June 2004, the European Commission issued a press release stating that, rather than launching a review of the Recommendation at that stage, it had decided to "reschedule the date for the launch of such a review

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<sup>36</sup> 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 Directive 2002/21/EC of the European Parliament and of the Council on a common regulatory framework for electronic communication networks and services, (2003/311/EC), OJ L 114/45, 8.5.2003.

until the end of 2005". Its reasons for delaying the review were, firstly, that a significant number of Member States had not even transposed the EC Communications Directives; secondly, many Member States had yet to complete the first round of requisite market analyses; thirdly, the pace of change in the markets for electronic communication was not such that an early review would appear justified; and, fourthly, launching a review could lead to substantial disruption for the NRAs and increase the level of uncertainty related to regulatory intervention.

A2.28 Until such a review has been concluded, the European Commission's 18 product and service markets listed in the Annex to the current Recommendation, which it has identified and recommended that NRAs should analyse, are the relevant markets that Ofcom must consider.

#### *Guidelines for market analysis and the assessment of SMP*

A2.29 The second document is guidelines<sup>37</sup> for market analysis and the assessment of SMP (the "SMP Guidelines") published, in accordance with Article 15(2) of the Framework Directive, by the European Commission in July 2002.

A2.30 As noted above, Ofcom is also required under the said Article 15(3) (as implemented in section 79(2) of the 2003 Act) to take the utmost account of the SMP Guidelines when identifying a services market (see further below for the market analysis (SMP) stage).

A2.31 Oftel published its own additional guidelines on the criteria to assess effective competition, which can be found at [http://www.ofcom.org.uk/static/archive/oftel/publications/about\\_oftel/2002/smpg0802.htm](http://www.ofcom.org.uk/static/archive/oftel/publications/about_oftel/2002/smpg0802.htm). These supplement the SMP Guidelines and have been taken into account by Ofcom, where appropriate.

#### *Ofcom's approach to services market identifications*

A2.32 There are two dimensions to the definition of a relevant market:

- the relevant products to be included in the same market; and
- the geographic extent of the market.

A2.33 In defining the markets in accordance with the principles of competition law, Ofcom's approach to service market identifications follows, to start with, that used by UK competition authorities (see, for instance, the competition law guideline by the Office of Fair Trading ("OFT") entitled '*Market Definition – Understanding competition law*', December 2004, that can be found at: <http://www.oft.gov.uk/NR/rdonlyres/972AF80C-2D74-4A63-84B3-27552727B89A/0/OFT403.pdf>) and is in line with those used by European and US competition authorities.

A2.34 Market boundaries are determined by identifying constraints on the price-setting behaviour of firms. There are two main competitive constraints to consider: how far it is possible for customers to substitute other services for those in question (i.e. demand side substitution); and how far suppliers could switch, or

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<sup>37</sup> Commission guidelines on market analysis and the assessment of significant market power under the Community regulatory framework for electronic communications networks and services, (2002/C 165/03), OJ C 165/6, 11.7.2002.

increase, production to supply the relevant products or services (i.e. supply-side substitution) following a price increase.

A2.35 In this assessment, supply side substitution will be considered as a low cost form of entry, which could take place within a relatively short period of time. The OFT states, in its above-mentioned OFT *Market Definition* guideline, the relatively short period to be within a year. That is, for supply side substitution to be relevant, there would need to be additional competitive constraints arising from entry into the supply of the service in question, from suppliers who are able to enter quickly and at low cost, by virtue of their existing position in the supply of other services. As discussed below, only those supply side substitution possibilities that are viable in the absence of unregulated wholesale inputs will be considered as relevant to the analysis.

A2.36 The concept of the 'hypothetical monopolist test' is a useful tool to identify close demand side and supply side substitutes. A product is considered to constitute a separate market if a hypothetical monopoly supplier could impose a small but significant, non-transitory price increase ("SSNIP") above the competitive level without losing sales to such a degree as to make this unprofitable. If such a price rise would be unprofitable, because consumers would switch to other products, or because suppliers of other products would begin to compete with the monopolist, then the market definition should be expanded to include the substitute products.

A2.37 There might be suppliers who provide other retail and wholesale services but who might also be materially present in the provision of demand side substitutes to the service for which the hypothetical monopolist has raised its price. However, such suppliers are not relevant to supply side substitution, as they supply services already identified as demand side substitutes. As such, their entry has already been taken into account and so supply side substitution cannot provide an additional competitive constraint on the hypothetical monopolist. However, the impact of expansion by such suppliers can be taken into account in the assessment of market power.

A2.38 Sometimes an additional consideration is whether there are common pricing constraints across customers, services or areas such that they should be included within the same relevant market even if demand and supply side substitution are not present.

#### *Relationship between the wholesale and retail markets*

A2.39 In this Explanatory Statement, the relevant markets have been considered both at the retail and the wholesale level. Consideration of the relevant retail markets logically precedes the analysis of the wholesale markets, since the demand for wholesale services is derived from the demand for retail services.

A2.40 The purpose of this review of the markets is to assess whether a provider has SMP in a wholesale market and to identify appropriate remedies to address the existence of market power, i.e. the identified competition problem.

A2.41 It is, therefore, necessary for the definition of retail markets to be undertaken in the absence of regulation of wholesale services. To do otherwise would mean that the wholesale market power assessment would depend on a retail market definition that relied on a wholesale remedy arising from the finding of wholesale

market power. This would be a circular and incorrect approach to market definition.

A2.42 Accordingly, the demand side and supply side substitution possibilities at the retail level are considered only if they are viable in the absence of regulated wholesale inputs.

#### *Retail geographic market*

A2.43 In addition to the products to be included within a market, market definition also requires the geographic extent of the market to be specified. The geographic market is the area within which demand side and/or supply side substitution can take place and is defined using a similar approach to that used to define the product market. Ofcom has considered the geographic extent of each relevant market covered in this market review.

A2.44 There are a number of possible approaches to geographic market definition. One approach would be to begin with a narrowly-defined area and then consider whether a price increase by a hypothetical monopolist in that narrowly defined area would encourage customers to switch to suppliers located outside the area (demand-side substitution) or operators outside the area to begin to offer services in the area (supply-side substitution). If supply and/or demand side substitution is sufficient to constrain prices then it is appropriate to expand the geographic market boundary.

A2.45 Ofcom recognises that in certain telecommunications (product) markets in the UK, there could be different competitive pressures in different geographic areas. An obvious example is local access where BT competes with cable operators who have local franchises. Another is trunk segments of leased lines. In these circumstances it might be possible to identify separate geographic markets for some services. However, a number of difficulties would then arise. In particular, the definition of separate geographic markets using the hypothetical monopolist test as outlined above would likely lead to a proliferation of markets. This, when considered along with the dynamic nature of telecommunications markets, would likely mean that the boundary between areas where there are different competitive pressures would be unstable and change over time, rendering the market definition obsolete. It is not clear that determining ex-ante where the boundary would be is an exercise that could be carried out with any degree of accuracy.

A2.46 Because of the difficulties associated with defining separate geographic areas, there is a risk that inappropriate decisions would be made about the imposition or removal of regulations, which could be detrimental to consumers and competition. In any case, even if separate narrow local markets were to be defined it is likely that BT would continue to have SMP in many of these markets. Therefore, such a detailed approach is unlikely to add significant benefit to the regulatory outcome being proposed.

A2.47 An alternative approach is to define geographic markets in a broader sense. This involves defining a single geographic market but recognising that this single market has local geographical characteristics. That is to say, recognising that within the single market there are areas where competition is more developed than in other areas. This avoids the difficulties of proliferation and instability.



### *European Commission's approach to market definition*

A2.48 In formulating its approach to market definition, Ofcom has taken due account of the Recommendation.

A2.49 The 7<sup>th</sup> recital to the Recommendation clearly states that the starting point for market definition is a characterisation of the retail market over a given time horizon, taking into account the possibilities for demand and supply side substitution. The wholesale market is identified subsequently to this exercise being carried out in relation to the retail market. This approach is repeated in section 3.1 of the Explanatory Memorandum to the Recommendation (the "EM") and is exactly that set out above and followed by Ofcom.

A2.50 Section 3.1 of the EM also states that, because any market analysis is forward looking, markets are to be defined prospectively taking account of expected or foreseeable technological or economic developments over a reasonable horizon linked to the timing of the next market review. Again, this is the approach followed by Ofcom.

A2.51 Furthermore, section 3.1 of the EM states that market definition is not an end in itself, but a means to assessing effective competition for the purposes of *ex ante* regulation. Ofcom has adopted an approach by which this consideration is at the centre of its analysis. The purpose of market definition is to illuminate the situation with regard to competitive pressures. For example, Ofcom's approach to supply side substitution explicitly identifies as the key issue the question of whether additional competitive constraints on pricing are brought to bear by additional suppliers entering the market. Thus, the key issue is not the market definition for its own sake, but an identification of the extent and strength of competitive pressures.

A2.52 Also, section 4 of the EM states that retail markets should be examined in a way that is independent of the infrastructure being used, as well as in accordance with the principles of competition law. Again, this approach is key to Ofcom's analysis. As seen from the above, Ofcom's approach is based on a competition law assessment of markets and an assessment of the extent to which switching among services by consumers constrains prices, irrespective of the infrastructure used by the providers of those services.

### *Current market definitions for fixed narrowband markets*

A2.53 The narrowband markets covered in this document were last assessed by Oftel, with its conclusions published in November 2003. Four of those markets were covered in one document, the Market Review 2003 Statement<sup>38</sup>, whereas fixed call termination was covered in a separate document, the Fixed Call Termination Statement<sup>39</sup>.

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<sup>38</sup> Document entitled 'Review of the fixed narrowband wholesale exchange line, call origination, conveyance and transit markets — Identification and analysis of markets, determination of market power and the setting of SMP conditions — Final Explanatory Statement and Notification' published by the Director General of Telecommunications on 28 November 2003;  
[http://www.ofcom.org.uk/legacy\\_regulators/oftel/narrowband\\_mkt\\_rvw/nwe/fixednarrowbandstatement.pdf](http://www.ofcom.org.uk/legacy_regulators/oftel/narrowband_mkt_rvw/nwe/fixednarrowbandstatement.pdf).

<sup>39</sup> Document entitled 'Review of fixed geographic call termination markets — Identification and analysis of markets, determination of market power and setting of SMP conditions — Final



A2.54 These documents defined the following markets for the purposes of regulation of wholesale narrowband interconnect services for the UK (excluding the Hull area in markets other than fixed call termination) in respect of BT:

- **Call origination**

*UK market definition:* Call origination on fixed public narrowband networks (paragraph 1(a)(vi) of the Notification in Annex A to the Market Review 2003 Statement).

*Commission's market definition:* Call origination on the public telephone network provided at a fixed location. For the purposes of this Recommendation, call origination is taken to include local call conveyance and delineated in such a way as to be consistent with the delineated boundaries for the markets for call transit and for call termination on the public telephone network provided at a fixed location (point 8 of the Annex to the Recommendation).

- **Local-tandem conveyance/transit ("LTC/LTT")**

*UK market definition:* Local-tandem conveyance and transit on fixed public narrowband networks (paragraph 1(a)(vii) of the Notification in Annex A to the Market Review 2003 Statement).

*Commission's market definition:* Call origination on the public telephone network provided at a fixed location. For the purposes of this Recommendation, call origination is taken to include local call conveyance and delineated in such a way as to be consistent with the delineated boundaries for the markets for call transit and for call termination on the public telephone network provided at a fixed location (point 8 of the Annex to the Recommendation).

- **Inter-tandem conveyance ("ITC") /inter-tandem transit ("ITT")**

*UK market definition:* Inter-tandem conveyance and transit on fixed public narrowband networks (paragraph 1(a)(viii) of the Notification in Annex A to the Market Review 2003 Statement).

*Commission's market definition:* Transit services in the fixed public telephone network. For the purposes of this Recommendation, transit services are taken as being delineated in such a way as to be consistent with the delineated boundaries for the markets for call origination and for call termination on the public telephone network provided at a fixed location (point 10 of the Annex to the Recommendation).

- **Single transit**

*UK market definition:* Single transit on fixed public narrowband networks (paragraph 1(a)(ix) of the Notification in Annex A to the Market Review 2003 Statement).

*Commission's market definition:* Transit services in the fixed public telephone network. For the purposes of this Recommendation, transit services are taken as being delineated in such a way as to be consistent with the delineated boundaries for the markets for call origination and for call termination on the public telephone network provided at a fixed location (point 10 of the Annex to the Recommendation).

- **Termination**

*UK market definition:* Fixed geographic call termination provided by BT (paragraph 1(a) of the Notification in Annex B to the Fixed Call Termination Statement).

*Commission's market definition:* Call termination on individual public telephone networks provided at a fixed location. For the purposes of this Recommendation, call termination is taken to include local call conveyance and delineated in such a way as to be consistent with the delineated boundaries for the markets for call origination and for call transit on the public telephone network provided at a fixed location (point 9 of the Annex to the Recommendation).

A2.55 For the purposes of this Explanatory Statement, Ofcom considered it appropriate for reasons set out in Section 2 of this document to review the markets of LTC/LTT and ITC/ITT.

## **Market (SMP) Analysis Stage**

### *General*

A2.56 The second market review stage concerns the assessment of competition in each identified services market to decide whether any undertaking has SMP.

A2.57 Article 16(1) of the Framework Directive provides that NRAs must, as soon as possible after the adoption of the Recommendation or any updating thereof, carry out an analysis of the relevant markets, taking the utmost account of the SMP Guidelines. Ofcom's obligation to take due account of the SMP Guidelines in this context is set out in section 79(3) of the 2003 Act.

A2.58 In carrying out a market analysis, the key issue for an NRA is to determine whether the market in question is effectively competitive. The 27<sup>th</sup> recital to the Framework Directive clarifies the meaning of that concept. Namely, "[i]t is essential that *ex ante* regulatory obligations should only be imposed where there is not effective competition, i.e. in 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".

A2.59 Thus, Article 16 further prescribes, in effect, what regulatory action NRAs must take depending upon whether or not the market in question has been found effectively competitive. If it has, then NRAs are prohibited to impose specific (SMP) obligations and must withdraw such obligations where they exist. On the other hand, where the market is not effectively competitive, the NRAs must identify the undertakings with SMP on that market and shall impose on them appropriate obligations.

- A2.60 Indeed, paragraphs 21 and 114 of the SMP Guidelines provide that merely designating an undertaking as having SMP on a given market without imposing any appropriate regulatory obligations is inconsistent with the new regulatory framework, notably Article 16(4) of the Framework Directive. In other words, NRAs must impose at least one regulatory obligation on an SMP operator.
- A2.61 Under the 2003 Act, the process of designating an undertaking as having SMP is referred to as the making of a market power determination under section 79. To reflect the provisions in Article 16, there is a close link in this analysis with the imposition of remedies. This is because section 45 of the 2003 Act details the various conditions that may be set under the new regime. Section 46 of the 2003 Act prescribes who those conditions may be imposed upon.
- A2.62 In relation to SMP services conditions, section 46(7) provides that they may be imposed on a particular person who is a communications provider or a person who makes associated facilities available and who has been determined to have significant market power in a “services market” (i.e. a specific market for electronic communications networks, electronic communications services or associated facilities). Accordingly, having identified the relevant market, Ofcom is required to analyse the market in order to assess whether any person or persons have SMP as defined in section 78 of the 2003 Act (Article 14 of the Framework Directive).
- Approach used to assess SMP*
- A2.63 Under the EC Communications Directives and the said section 78, the concept of SMP is defined so that it is equivalent to the competition law concept of dominance. Article 14(2) of the Framework Directive provides: “[a]n undertaking shall be deemed to have 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”.
- A2.64 Further, Article 14(3) of the Framework Directive provides that: “[w]here an undertaking has significant market power on a specific market, it may also be deemed to have significant market power on a closely related market, where the links between the two markets are such as to allow the market power held in one market to be leveraged into the other market, thereby strengthening the market power of the undertaking”.
- A2.65 Therefore, in the relevant market, one or more undertakings may be designated as having SMP where that undertaking, or undertakings, enjoy a position of dominance. Also, an undertaking may be designated as having SMP where it could lever its market power from a closely related market into the relevant market, thereby strengthening its market power in the relevant market.
- A2.66 In assessing whether BT has SMP in the relevant markets in question, Ofcom has taken the utmost account of the SMP Guidelines as well as Oftel’s supplemental guidelines, as referred to above, in its market power assessment. In particular, the analyses in Sections 4 and 5 provide an assessment of SMP in the two markets in question against the criteria set out in those guidelines, such as market shares, ease of market entry, and economies of scale.

*The relationship between the market reviews and Competition Act 1998 and Enterprise Act 2002 investigations*

A2.67 The economic analyses carried out in this Explanatory Statement are for the purposes of determining whether an undertaking or undertakings have SMP in relation to the markets in question. It is without prejudice to any economic analysis that may be carried out in relation to any investigation or decision pursuant to the Competition Act 1998 or the Enterprise Act 2002.

A2.68 The fact that economic analysis carried out for a market review is without prejudice to future competition law investigations and decisions is recognised in Article 15(1) of the Framework Directive which provides that: "...The recommendation shall identify...markets...the characteristics of which may be such as to justify the imposition of regulatory obligations ...without prejudice to markets that may be defined in specific cases under competition law...".

A2.69 Its intention is further evidenced in the SMP Guidelines, which state:

- Paragraph 25: "... Article 15(1) of the Framework Directive makes clear that the market to be defined by NRAs for the purpose of *ex ante* regulation are without prejudice to those defined by national competition authorities and by the Commission in the exercise of their respective powers under competition law in specific cases." (repeated in paragraph 37);
- Paragraph 27: "...Although NRAs and competition authorities, when examining the same issues in the same circumstances and with the same objectives, should in principle reach the same conclusions, it cannot be excluded that, given the differences outline above, and in particular the broader focus of the NRAs' assessment, markets defined for the purposes of competition law and markets defined for the purpose of sector-specific regulation may not always be identical"; and
- Paragraph 28: "...market definitions under the new regulatory framework, even in similar areas, may in some cases, be different from those markets defined by competition authorities."

A2.70 In addition, it is up to all providers to ensure that they comply with their legal obligations under all the laws applicable to the carrying out of their businesses. It is incumbent upon all providers to keep abreast of changes in the markets in which they operate, and in their position in such markets, which may result in legal obligations under the Competition Act 1998 or Enterprise Act 2002 applying to their conduct.

## **The need for *ex-ante* regulation**

### *Nature of the competition problem identified*

A2.71 Before turning to the last stage market review stage concerning remedies, it is necessary to consider whether competition law remedies are sufficient to address the problem. This consideration is necessary to establish, in line with the above-mentioned 27<sup>th</sup> recital to the Framework Directive, whether or not a market is effectively competitive. (In this context, it is to be noted that the importance of identifying that problem reappears under Article 8(4) of the Access and Interconnection Directive. This is because obligations imposed in accordance

with Article 8 shall be based on the nature of the problem identified, proportionate and justified in the light of the objectives laid down in Article 8 of the Framework Directive.)

A2.72 Ofcom's own guidelines on Impact Assessment note that Ofcom will consider the option of no regulation in its impact assessment process. See [www.ofcom.org.uk/about/account/policy\\_making/#content](http://www.ofcom.org.uk/about/account/policy_making/#content) for further details.

A2.73 In this light, it is considered below whether *ex ante* regulation is justified in the markets identified in Sections 4 and 5 or whether it would be sufficient to rely on competition law alone to address market failures, while noting the European Commission's view in paragraphs 21 and 114 of the SMP Guidelines about imposing at least one SMP remedy.

*Appropriate to promote the development of competition*

A2.74 As a competitive market will produce a more efficient outcome than a regulated market, the promotion of competition is central to securing the best deal for the consumer in terms of quality, choice and value for money.

A2.75 Where markets are effectively competitive, *ex post* competition law is sufficient to deal with any competition abuses that may arise. However, without the imposition of *ex ante* regulations to promote actively the development of competition in a non-effectively competitive market, it is unlikely that *ex post* general competition law powers will be sufficient to ensure that effective competition becomes established. For example, this is because *ex post* powers prohibit abuse of dominance rather than the holding of a dominant position. *Ex-ante* powers can be utilised to reduce the level of market power in a market and thereby encourage effective competition to become established.

A2.76 The risk is not all one way as use of some *ex ante* measures can themselves limit or add nothing to the development of competition. Ofcom has recognised this in removing some regulation where markets are not effectively competitive.

A2.77 Ofcom considers that *ex ante* regulation is necessary in most of the markets covered by this Explanatory Statement and Notification. The remedies considered in Section 4 are appropriate to promote the development of competition in downstream narrowband markets. A failure to regulate BT in these markets is likely to affect the development of competition in that competing providers would be unlikely to provide intermediate or retail services without wholesale services provided by BT. In the absence of regulation, BT would have little incentive to provide such wholesale services.

A2.78 It is preferable to apply regulation at the wholesale level as this both addresses SMP issues in the wholesale markets and promotes competition in downstream markets that rely on wholesale inputs. This fits with the requirement that NRAs take measures which meet the objective of encouraging efficient investment in infrastructure and promoting innovation (see Article 8(2) of the Framework Directive and section 4 of the 2003 Act). The regulation of wholesale markets encourages competing providers to purchase wholesale products and combine them with their own networks to create products in competition with BT.

### *Characteristics of communications markets in general*

A2.79 Generally, the case for *ex ante* regulation in communications markets is based on the existence of market failures which, by themselves or in combination, mean that competition might not be able to become established if the regulator relied solely on its *ex post* competition law powers established for dealing with more conventional sectors of the economy. Therefore, it is appropriate for *ex-ante* regulation to be used to address these market failures and entry barriers that might otherwise prevent effective competition from becoming established. By imposing *ex ante* regulation that will promote competition, it may be possible to reduce the need for such regulation as markets become more competitive, with greater reliance on *ex-post* competition law.

A2.80 The European Commission has stated, in paragraph 3 of section 3.2 of the EM, that *ex ante* regulation is justified: "[...] where the compliance requirements of an intervention to redress a market failure are extensive (e.g. the need for detailed accounting for regulatory purposes, assessment of costs, monitoring of terms and conditions including technical parameters etc) or where frequent and/or timely intervention is indispensable, or where creating legal certainty is of paramount concern.[...]." This is the case for many markets where persistent SMP leads to a risk of a firm setting excessive prices and the need for efficiency incentives, where a charge control would be justified, or where there is likely to be a need for intervention to set detailed terms and conditions for access to networks. Indeed, this is the case for all the markets dealt with in this review.

### *Market dominance*

A2.81 Although communications markets have in general become increasingly competitive over time, this is from a position in which most were controlled by a legacy monopoly operator. The increase in competition that has occurred inevitably reflects the imposition of *ex ante* regulation to counter the market power of the legacy operator. Moreover, despite this, the legacy operator remains, in Ofcom's view, dominant in all except one of the markets in this review. Therefore, it is appropriate to continue to impose *ex ante* regulations in these markets in order to ensure that effective competition can become established.

### *Network externality effects*

A2.82 Externality effects are present in the markets in this review. In particular, the network externality effect, which means that the value of a network to its users increases more than proportionately with the number of subscribers, gives the large incumbent network a great advantage over potential competitors. For example, the value of a large network might be little affected if it refused to deliver calls to or accept calls from a much smaller entrant, but the latter might find it impossible to attract subscribers as a result. As a consequence, this would enable the incumbent to exclude rivals from the market by refusing to interconnect with them or doing so only on onerous terms.

A2.83 General *ex post* competition law powers may not be sufficient to address the effects of the network externality. This is because the network externality effect generally re-enforces a dominant position and under general competition law there is no prohibition on holding a position of dominance in itself. Therefore, it may be more appropriate to address the impact of network externality through *ex*

*ante* obligations, for example by requiring interconnection with the incumbent's network.

### *Entry barriers*

A2.84 The communications networks in this review are characterised by economies of scale, that is, average costs fall as output increases. Economies of scale result from the fact that a high proportion of the costs of a communications network are fixed while marginal costs (the costs of an extra unit of output) are relatively low.

A2.85 While the extent of economies of scale varies in different parts of the network, their existence means that a large network will tend to have lower average costs than a smaller one. Successful entry by new network operators will therefore require significant investment and most of this will be sunk costs, in the sense that the costs will not be recoverable if the entrant decides to exit the market. Significant sunk costs create an asymmetry in the market between incumbents and potential entrants that the former could exploit to deter entry, if allowed to. Incumbents could exploit this asymmetry by signalling to a potential entrant that, if it were to enter the market, prices would be too low to cover sunk costs. Entry might therefore be deterred.

A2.86 Also, although entry at the retail level by operators without their own networks is likely to require relatively smaller sunk investments, it is also likely to require regulated supply of wholesale inputs if retail competition is to become established where there is market power at the network level.

A2.87 Therefore, in the communications markets covered by this Explanatory Statement, especially where there is a requirement for larger sunk investments, *ex ante* regulation is appropriate to address the effect of this barrier to entry.

A2.88 Ofcom does recognise, however, that inappropriate *ex ante* regulation can have the effect of limiting competition. In formulating remedies to overcome SMP, it is important to consider the extent to which the proposed remedies will address the specific problem identified.

## **Remedies Stage**

### *Subject matter of the SMP remedies*

A2.89 The third and final market review stage concerns remedies. As noted above, Article 16 of the Framework Directive dictates the imposition or removal of SMP remedies depending upon whether or not a finding of SMP in an identified services market has been made. Where an SMP finding has been made, Ofcom will consider what appropriate SMP remedies are available.

A2.90 Under section 45 of the 2003 Act, Ofcom is empowered generally to set SMP services conditions authorised or required by sections 87 to 92. The latter implement Articles 9 to 13 of the Access and Interconnection Directive and Articles 17 to 19 of the Universal Service Directive. In addition, Ofcom's power to set such conditions includes additional powers specified in section 45(10), such as powers to include provisions in SMP services conditions for Ofcom to make directions in respect of specified markets.

A2.91 The SMP obligations relevant to the markets covered by this Explanatory Statement are discussed in Section 6.



A2.92 Section 46 of the 2003 Act provides that SMP services conditions set under section 45 may only be applied if the person to whom they are to apply is a communications provider (or a person who makes associated facilities available) and is a person whom Ofcom has determined to be a person having SMP in a services market. It is therefore important to consider the precise identity of the regulated entity on whom it is appropriate to impose obligations.

#### *Regulated entity*

A2.93 As noted above, section 46 provides that a person to whom an SMP services condition is applied must be a 'communications provider' or a 'person' who makes associated facilities available and a 'person' who Ofcom has determined to have SMP in a specific market for electronic communications networks, electronic communications services or associated facilities (i.e. the 'services market').

A2.94 Article 16 of the Framework Directive requires that, where an NRA determines that a relevant market is not effectively competitive, it shall identify "undertakings" with SMP on that market and impose appropriate specific regulatory obligations. For the purposes of EC competition law, "undertaking" includes companies within the same corporate group (*Viho v Commission* Case C-73/95 P [1996] ECR I-5447), for example, where a company within that group is not independent in its decision making.

A2.95 Ofcom considers it appropriate to prevent a dominant provider to whom a SMP service condition is applied, which is part of a group of companies, exploiting the principle of corporate separation. The dominant provider should not use another member of its group to carry out activities or to fail to comply with a condition, which would otherwise render the dominant provider in breach of its obligations. For this reason, Ofcom proposes that the obligations detailed in this Explanatory Statement and Notification should apply to British Telecommunications plc and any BT subsidiary or holding company, or any subsidiary of that holding company, all as defined by Section 736 of the Companies Act 1985 as amended by the Companies Act 1989.

#### *The legal tests*

A2.96 However, before Ofcom can set or modify SMP services conditions on such a regulated entity, it must be satisfied that certain legal tests have been satisfied in relation to each and every condition.

A2.97 In Section 6 and Annex 4 of this Explanatory Statement, Ofcom sets out its reasons explaining why those tests would be satisfied based on evidence presently before Ofcom. In addition to need of satisfying the general and specific duties, the appropriateness of the remedy and identifying the nature of the competition problem mentioned above, Ofcom must satisfy a number of additional tests.

A2.98 First, under section 47(2) of the 2003 Act, Ofcom must show for each and every SMP services condition that it is:

- *objectively justifiable* in relation to the networks, services, facilities, apparatus or directories to which it relates;

- *not such as to discriminate unduly* against particular persons or against a particular description of persons;
- *proportionate* to what the condition or modification is intended to achieve; and
- in relation to what it is intended to achieve, *transparent*.

A2.99 Secondly, each of the tests set out in section 87(4) of the 2003 Act which Ofcom considers relevant must be satisfied. That section requires that Ofcom:

“...must take into account, in particular, the following factors—

- (a) the technical and economic viability, having regard to the state of market development, of installing and using facilities that would make the proposed network access unnecessary;
- (b) the feasibility of the provision of the proposed network access;
- (c) the investment made by the person initially providing or making available the network or other facility in respect of which an entitlement to network access is proposed;
- (d) the need to secure effective competition in the long term;
- (e) any rights to intellectual property that are relevant to the proposal; and
- (f) the desirability of securing that electronic communications services are provided that are available throughout the member States.”

A2.100 It is to be emphasised that this list is not exhaustive and other reasons can therefore be added by Ofcom for imposing the access obligation(s) in question.

A2.101 Thirdly, in addition to the above-mentioned tests, Ofcom must also satisfy the tests set out in section 88 of the 2003 Act in relation to network access pricing etc. obligations, namely: price control; cost orientation and cost recovery rules; use of cost accounting system rules; obligations to adjust prices.

A2.102 Section 88 only allows Ofcom to impose such obligations where:

- it appears to Ofcom from the market analysis carried out for the purpose of setting that condition that there is a relevant risk of adverse effects arising from price distortion (see below for the meaning of this term); and
- It also appears to Ofcom that the setting of the condition is appropriate for the purposes of promoting efficiency, promoting sustainable competition, and conferring the greatest possible benefits on the end-users of public electronic communications services. In considering these matters, Ofcom may have regard to the prices at which services are available in comparable competitive markets and may determine what they consider to represent efficiency by using such cost accounting methods as they think fit.

A2.103 There is a relevant risk of adverse effects arising from price distortion if the SMP designated undertaking might fix and maintain some or all of its prices at an

excessively high level, or impose a price squeeze, so as to have adverse consequences for end-users of public electronic communications services.

A2.104 In addition, Ofcom must show that in setting the network access pricing obligation it has taken account of the extent of the SMP provider's investment in the matters to which the condition relates.

A2.105 It is to be noted that the term "price control" has not been defined in the EC Communications Directives. The 20<sup>th</sup> recital to the Access and Interconnection Directive suggests that it could cover a range of obligations concerning prices:

"Price control may be necessary when market analysis in a particular market reveals inefficient competition. The regulatory intervention may be relatively light, such as an obligation that prices for carrier selection are reasonable as laid down in Directive 97/33/EC, or much heavier such as an obligation that prices are cost oriented to provide full justification for those prices where competition is not sufficiently strong to prevent excessive pricing. In particular, operators with significant market power should avoid a price squeeze whereby the difference between their retail prices and the interconnection prices charged to competitors who provide similar retail services is not adequate to ensure sustainable competition. When a national regulatory authority calculates costs incurred in establishing a service mandated under this Directive, it is appropriate to allow a reasonable return on the capital employed including appropriate labour and building costs, with the value of capital adjusted where necessary to reflect the current valuation of assets and efficiency of operations. The method of cost recovery should be appropriate to the circumstances taking account of the need to promote efficiency and sustainable competition and maximise consumer benefits."

A2.106 Article 12 of that Directive, however, expressly empowers NRAs to impose obligations on operators to meet reasonable requests for access to, and use of, specific network elements and associated facilities, *inter alia* in situations where the NRA considers that denial of access or unreasonable *terms and conditions* having a similar effect would hinder the emergence of a sustainable competitive market at the retail level, or would not be in the end-user's interest, and that NRAs may attach to those obligations conditions covering fairness, reasonableness and timeliness.

A2.107 In the light of the potential interplay between these provisions, Ofcom has addressed the section 88 test also under the requirement to provide network access on fair and reasonable terms and conditions, including charges.

#### *The material change test*

A2.108 Under specific circumstances, Ofcom can set, modify or revoke an SMP services condition without conducting a new market analysis process. The framework for doing this, and Ofcom's intention to follow this procedure for certain of the services covered in this Explanatory Statement, are described below.

A2.109 Where Ofcom seeks to set, modify or revoke an SMP services condition, it may only do so under section 86 of the 2003 Act if it is satisfied that there has not, since the condition was set or last modified, or since the relevant market power determination was made (as the case may be), been a material change in

the market identified or otherwise used for the purposes of the market power determination by reference to which the condition was set or last modified.

A2.110 The alternative way of setting, modifying or revoking an SMP services condition, rather than satisfying that material change test, is for Ofcom to review, under section 84 of the 2003 Act, the market power determination by reference to which the condition in question was set.

A2.111 Section 84 requires Ofcom to carry out further analyses of the identified services market either:

- where Ofcom considers it an appropriate interval to do so for the purposes of reviewing market power determinations made on the basis of an earlier analysis or deciding whether to make proposals for the modification of SMP services conditions set by reference to a market power determination made on such a basis (section 84(2)); or
- as soon as reasonably practicable after recommendations are made by the European Commission that affect the matters that were taken into account, or could have been taken into account, in the case of the last analysis of the market in question (section 84(3)).

A2.112 For reasons set out in Section 2, Ofcom considers it an appropriate interval, at present, to carry out further analyses of the LTC and ITC/ITT markets both to review the relevant market power determinations and to propose such modifications to the applicable SMP services conditions as are appropriate.

A2.113 As regards the other identified services markets covered in this Explanatory Statement (i.e. fixed call origination, fixed call termination and single transit) in which Ofcom is setting the new NCCs discussed in this document, Ofcom is, in accordance with section 86(1)(b) of the 2003 Act, setting those NCCs in the form of SMP services conditions by reference to the respective market power determinations made in relation to those markets in which OFCOM is satisfied there have been no material change since those determinations were made in November 2003. Ofcom's reasons for maintaining that view are set out, in particular, at Annex 5.

A2.114 In this context, it is to be noted that, were any material changes in economic and technological developments to occur in these markets in the future, Ofcom will consider appropriate timings for carrying out a market review of them under section 84(2) of the 2003 Act. As seen above, it is also possible that the European Commission would make a new Recommendation within the proposed period of the new NCCs that might affect the matters previously taken into account in making BT's market power determinations made in 2003. If so, this would trigger an Ofcom review of the relevant markets under section 84(3) of the 2003 Act.

#### *ERG Common Position on Remedies*

A2.115 At a plenary meeting on 1-2 April 2004, the European Regulators Group ("ERG") adopted a revised version of its document entitled 'ERG Common Position on the approach to Appropriate remedies in the new regulatory framework', ERG (03) 30rev1, (the "Common Position on Remedies").

A2.116 That document sets out NRAs' views on imposing remedies in a manner that contributes to the development of the internal market and ensures a consistent application of the new regulatory framework under the EC Communications Directives.

A2.117 Ofcom has therefore taken into account those views in considering appropriate remedies. For instance, the first principle set out in *The Common Position on Remedies* states that the "NRA must produce reasoned decisions in line with their obligations under the Directives [and] that the remedy selected [must] be based on the nature of the problem identified". As explained in Section 6 of this Explanatory Statement, Ofcom's decisions are based on the nature of the competition problems identified. More generally, Ofcom considers that its approach to determining SMP remedies is consistent with the *Common Position on Remedies* which in turn reflects the requirements of the EC Communications Directives which are addressed in this Explanatory Statement.

## **Ofcom's Notifications of Proposals**

### *Public (national) consultation & notification of Ofcom's findings*

A2.118 Ofcom is required to give interested parties an opportunity to comments on its proposals contained in this Explanatory Statement. That statutory obligation to consult is set out in:

- section 49(4) of the 2003 Act in respect of any proposed modifications to Directions given under SMP services conditions, such as Condition AA1(a), see Annex 6 of this document; and
- sections 48(2) and 80(1) of the 2003 Act in respect of any proposals on services market identifications, market power determinations and modifications to the relevant SMP services conditions, of the 2003 Act

in accordance with Article 6 of the Framework Directive where the proposed draft measures have a significant impact on the relevant markets.

A2.119 Ofcom is entitled, by virtue of section 80(2) of the 2003 Act, to publish a single notification of its proposals as to services market identifications, market power determinations and modifications to the relevant SMP services conditions.

A2.120 At Annex 5 (Part I) of its consultation document of 23 March 2005, Ofcom published a single notification containing all such proposals. Also, at Part II of that Annex, Ofcom published its statutory notification in respect of its proposed withdrawal of the Credit Vetting Direction in specified respects.

A2.121 To conclude the consultation process and in making its final decisions in respect of services market identifications, market power determinations and modifications to, as well as setting and revocation of, the relevant SMP services conditions, Ofcom is required to publish a notification under sections 48(1), 79(4) and 86 of the 2003 Act. Again, by virtue of section 79(5) of the 2003 Act, Ofcom may publish a single notification in respect of all of those matters. Ofcom is therefore publishing such a notification at Annex 3 (Part I) of this Explanatory Statement. The withdrawal of the Credit Vetting Direction in specified respects is published at Part II of that Annex.

*Obligation to inform the European Commission, other NRAs and the Secretary of State – Parallel consultation under Article 7 & notification of Ofcom's findings*

A2.122 As required by Article 7(3) of the Framework Directive and sections 50 and 81 of the 2003 Act, draft decisions contained in the consultation document were also sent to the European Commission, the NRAs of every other Member State and the Secretary of State.

A2.123 As Ofcom considered that those draft measures might affect trade between Member States, the European Commission and the other NRAs were thus provided with an opportunity to comment on Ofcom's proposals. The European Commission responded to this consultation to state that it had examined Ofcom's notifications, but that it had no comments.

A2.124 If the European Commission believes that the market definitions proposed in the consultation document, or Ofcom's proposals to designate BT as having SMP in the LTC market and to not designate BT as having in the ITC/ITT market SMP, would create a barrier to the single market or if it has serious doubts as to its compatibility with Community law, and issues a notification under Article 7(4) of the Framework Directive, Ofcom would be required by section 82 of the 2003 Act to delay adoption of these draft measures for a further period of two months while the European Commission considered its position. However, as seen from the European Commission's response mentioned above, it had no comments on Ofcom's proposals and it has thus not made a notification for the purposes of the said Article 7(4).

A2.125 In accordance with Article 7(5) of the Framework Directive and sections 50 and 81 of the 2003 Act, Ofcom has sent copies of its final measures (that is to say, this Explanatory Statement including the statutory notification and withdrawal of direction in specified respects as published in Parts I and II, respectively, of Annex 3 of this document) to the European Commission and the Secretary of State.

*Steps following the outcome of the consultation process*

A2.126 When Ofcom has considered any representations duly made in response to the proposals set out in this document, including any made by the European Commission and other NRAs, it may under sections 48(5) and 80(6) of the 2003 Act give effect to these proposals, with or without modifications, by making the services market identifications, market power determinations and modifications to the SMP services conditions in question. Ofcom would do so by publishing a further notification accompanied by a further and final explanatory statement. Thereafter, the markets and the new regulatory remedies that have been imposed will be reviewed at appropriate intervals, as discussed above. As regards the proposed modified directions, Ofcom may under section 49(9) of the 2003 Act give effect to them, with or without modifications, after having considered any consultation responses.

A2.127 As discussed further in Section 6 of this Explanatory Statement, Ofcom has decided to give effect to its proposals with certain modifications. However, for reasons set out in that Section, Ofcom does not consider that its final decisions in these respects have been modified (as compared to its initial proposals) to such an extent that it could be regarded as substantially and materially changed from its initial proposals. Rather, Ofcom has made only such modifications necessary to take into account certain consultation responses and to give effect to matters

implicitly clear from its initial proposals. Therefore, Ofcom considers that, on the most basic features of its proposals, BT and other stakeholders have been given a sufficient and adequate opportunity to express their views and so influence Ofcom. As a result, Ofcom does not consider there is a need to re-consult on these non-material modifications.

## **Impact Assessment**

A2.128 The analysis presented in Section 6 of this document, when read in conjunction with the rest of this document, represents an Impact Assessment ("IA"), as defined by section 7 of the 2003 Act.

A2.129 IAs provide a valuable way of assessing different options for regulation and showing why the preferred option was chosen. They form part of best practice policy-making and are commonly used by other regulators. This is reflected in section 7 of the 2003 Act, which means that generally we have to carry out IAs where our proposals would be likely to have a significant effect on businesses or the general public, or when there is a major change in Ofcom's activities. In accordance with section 7, in producing the IA in this document Ofcom has had regard to such general guidance as it considers appropriate, including related Cabinet Office guidance.