

**Jornadas sobre a Regulação dos Mercados
de Telecomunicações**



Towards a new telecoms regulatory framework for Europe

**Luis Enriquez
Lisbon, November 5, 2002
McKinsey & Company, Inc**

KEY MESSAGES



- Liberalization of telecommunications markets has generated huge medium term benefits to consumers but at significant cost to industry profitability in the fixed sector
- The regulatory debate is far from over: new EU regulation calls for a change in the regulatory frameworks of all Member States over the next year. The impact on the industry could be huge.
- As countries implement the new EU directives, Portugal must carefully evaluate both the short term and long term impact of regulation on the industry

EUROPEAN TELECOM MARKETS HAVE BEEN LIBERALISED OVER THE LAST 4-6 YEARS



1996 - 1997

Creation of a regulatory framework for the liberalisation of the telecom sector

1998 - 2001

Transposition of the European regulatory framework to the Member States

Liberalised markets

Content

- Adoption of a series of EU directives to achieve the liberalisation of the telecoms industry
 - Access (open network-provision)
 - Universal service
 - Interconnection
 - Licensing
 - Data protection
- Gradual implementation of the new framework in the Member States:
 - Before/in 1998: Holland, Finland, Sweden and UK*
 - 1998/1999: Germany, Spain, Denmark, France, Belgium, Austria and Norway
 - 2000: Portugal and Greece

Effects on telecom markets

- Abolition of privileges and exclusive rights of wireline incumbent operators
- Entry of new wireline and wireless operators

* UK started the liberalisation movement in 1984

REGULATORY FOCUS HAS BEEN VERY DIFFERENT IN WIRELINE AND WIRELESS



In wireline, asymmetric regulation aimed at facilitating market entry of new competitors . . .

- **Opening** of essential incumbent's **network elements** to competitors
- **Cost oriented interconnection obligations** for incumbent operators
- Definition of **Universal Service obligations** and establishment of financing methods
- **Pricing obligations** to incumbent operators (price-cap, price controls, limited commercial flexibility, etc...)
- Flexible **licensing** process

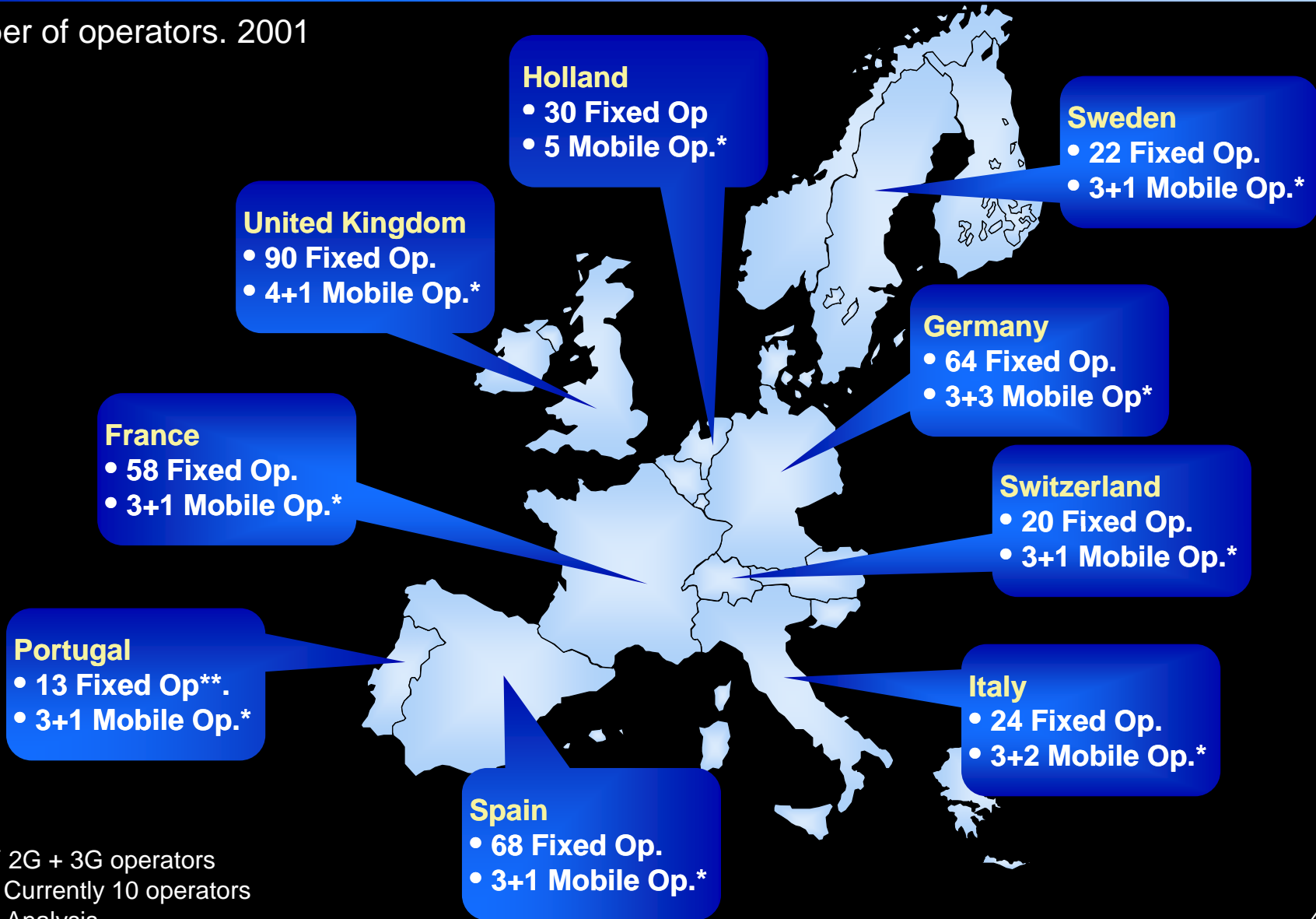
. . . in wireless, less intrusive regulatory intervention to foster the sector's development and growth

- **Non-regulated access**
- Loosely regulated **interconnection prices**
- **Progressive entry of new operators** with each technology cycle
- Freedom for each Member State to establish **procedures for spectrum licensing** (auction, beauty contest)
- No retail **price regulation**

EUROPEAN CONSUMERS HAVE BENEFITED FROM GREATER CHOICE ...



Number of operators. 2001



* 2G + 3G operators

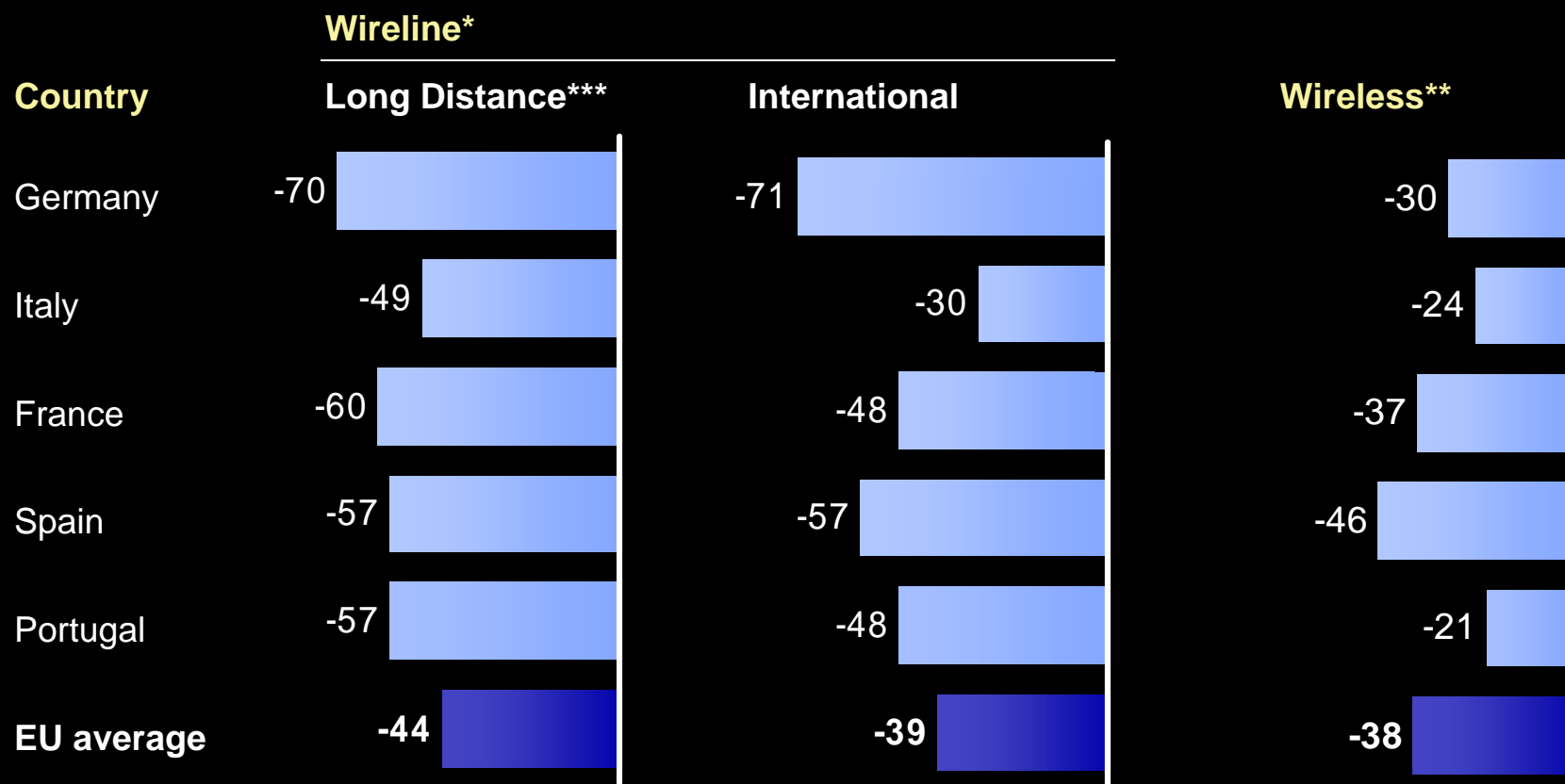
** Currently 10 operators

Source: Analysis

...SIGNIFICANT PRICE DECLINES...



Accumulated tariff reductions 1998-2001 . Percentage



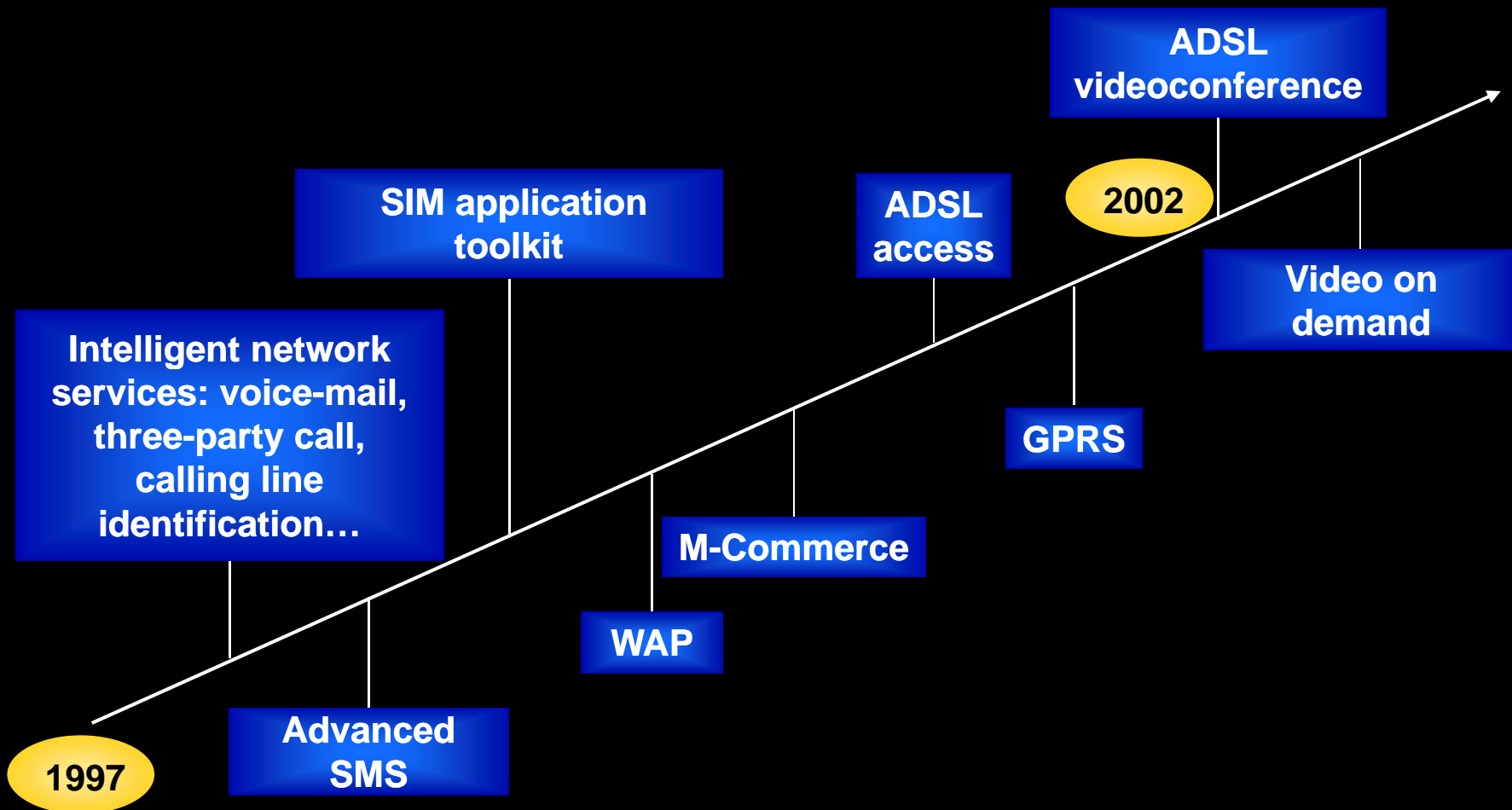
* Three-minute call in peak-time. Includes start up cost and does not include VAT

** Tariffs calculated as ARPU/MOU

*** November 2001

Source: European Commission; EMC; Analyst reports

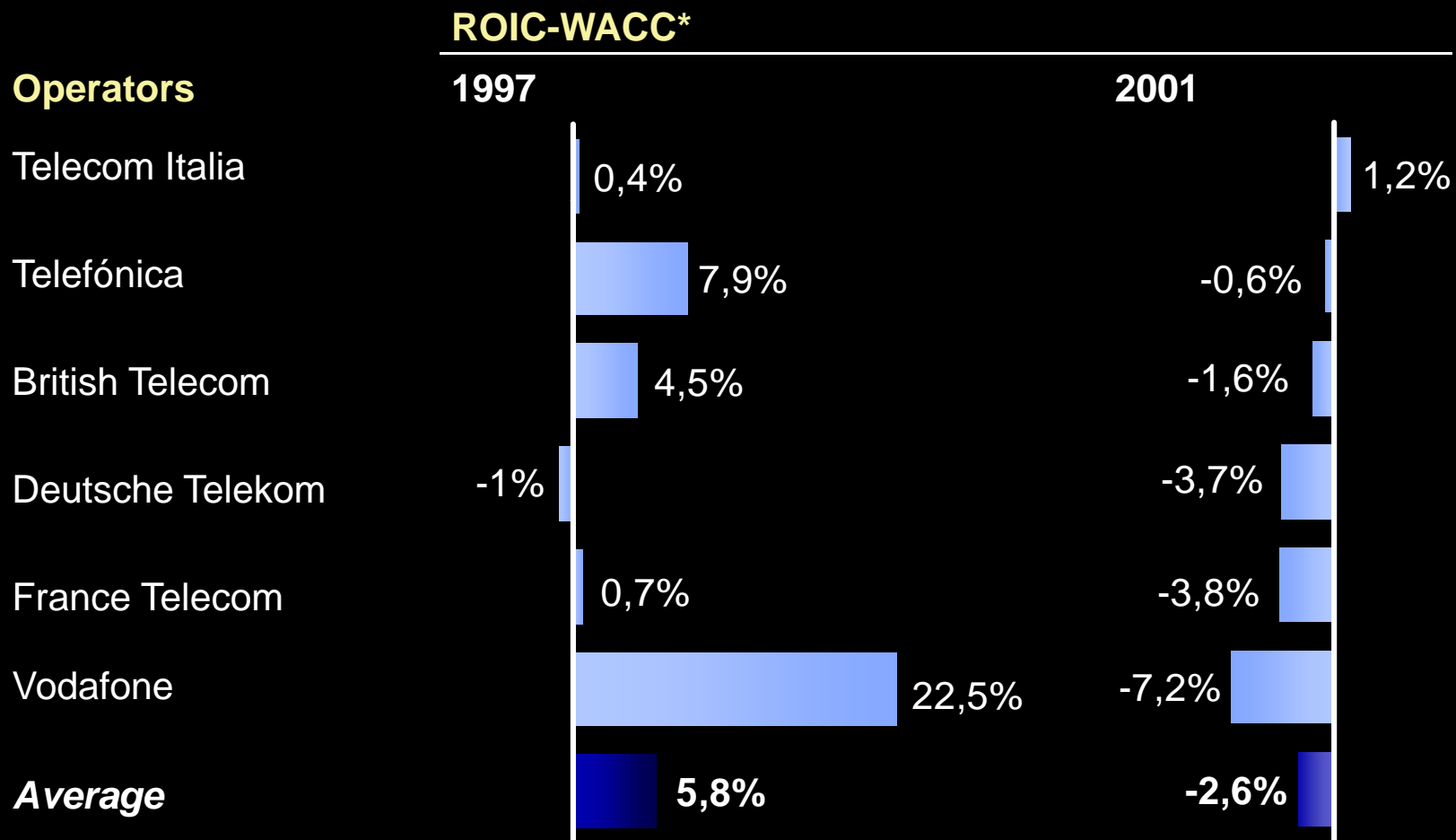
...AND PROLIFERATION OF INNOVATIVE SERVICES



HOWEVER, RETURNS HAVE FALLEN BELOW COST OF CAPITAL ...



Percentage



* ROIC net of UMTS licenses

Source: Datastream; Bloomberg

THE SEVERE INDUSTRY CRISIS PUTS IS ALREADY HAVING SERIOUS CONSEQUENCES



Downwards trend in industry results...

- *Record breaking losses in telecom operators*
- *Several attackers going bankrupt*
- *Difficulties for new operators to achieve EBITDA breakeven*

... creates doubts about the sustainability of the current model

- Major job cuts
- Sharp reductions in CAPEX
- Delays in new projects

RECENTLY ISSUED EU DIRECTIVES CALL FOR AN EVOLUTION OF REGULATORY FRAMEWORKS IN ALL MEMBER STATES



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Liberalised markets

2002 Evolution of

regulatory frameworks in acknowledgement of progress in the liberalization

process

- Publication* of a new series of EC Directives to advance in the telecoms liberalization process in the direction of gradual deregulation:
 - Framework directive
 - Access directive
 - Authorisation directive
 - Data Protection directive
 - Decision on Spectrum
 - Recommendation on Relevant Markets
- Requirement to change telecommunications laws in all Member States by 24 July, 2003

* UK started the liberalisation movement in 1984

** Main body of new regulation framework published in the Official Journal of the European Communities on 24 April, 2002. Guidelines on Relevant Markets published on 17 June, 2002

THE “SPIRIT” OF THE NEW EUROPEAN DIRECTIVES IS THE GRADUAL DEREGULATION OF THE TELECOM MARKETS



Guiding principles

- Gradual deregulation of telecommunications markets as effective competition is attained
- Ex-post application of general Competition Law to gradually replace telecom-specific ex-ante regulation
- Rigorous market analysis according to general rules of Competition Law for determination of significant market power (SMP) and imposition of obligations to dominant operators
- Proportionality between obligations imposed to dominant operators and the lack of effective competition in the markets
- No inappropriate ex-ante regulation of emerging markets

A BASIC PROCEDURE IS DEFINED FOR MARKET ANALYSIS AND IMPOSITION OF OBLIGATIONS TO DOMINANT OPERATORS



1 Market definition at European level

- European Commission recommends list of markets to be analysed by NRAs
- Draft list recently published for public consultation

2 Market definition at national level

- NRAs to define list of markets to be analyzed at national level
- EC has right of veto on any market not included in its recommendation

3 Competitiveness analysis

- NRAs to analyse, under defined periods, the competitive situation of each market according to general competition criteria

4 SMP* designation and imposition of obligations

- NRAs, to identify SMP operators in non-competitive markets
- NRAs to impose certain obligations to SMP operators proportionate to competitive constraints

A DRAFT LIST OF RELEVANT PRODUCT AND SERVICE MARKETS HAS BEEN PUBLISHED FOR PUBLIC CONSULTATION



Relevant markets

Retail

- Access to fixed networks
- Services from fixed networks
- Leased lines

- **No retail market in wireless**
- **Broadband not explicitly separated**

Wholesale

- Call origination on fixed networks
- Call termination on individual fixed networks
- Wholesale local access for broadband Internet services
- Local dedicated capacity (Wholesale local or leased lines)
- Call termination on individual mobile networks
- National market for international roaming
- Broadcasting transmission services and distribution networks

- **Termination markets are “individual” (i.e., all operators considered dominant)**
- **Roaming defined at national level**
- **Broadband explicitly separated**
- **Broadcasting market introduced**

THE NEW DIRECTIVES OPEN UP SEVERAL REGULATORY TOPICS ...



Main aspects introduced

Framework Directive

- Definition of NRA functions and competences
- Definition of “significant market power” (SMP) in line with Competition Law
- New methodology for the analysis of competition in relevant markets
- Inclusion of TV and radio distribution networks within the scope of telecommunications law

Access Directive

- Generalization of “access” definition, extending the potential regulation to new elements
- Principle of “technological neutrality”
- Regulation of “maxima”, to be applied case-by-case to tackle specific market failures

Universal Service Directive

- Functional access to Internet (narrowband) introduced in USO
- Retail regulation to be used only when wholesale regulation has proved ineffective

Authorization Directive

- Introduction of a general authorization that simplifies and harmonizes procedures to assign licenses
- Number of licenses to be limited only for the sake of efficient use of scarce resources

Data protection Directive

- Reinforcement to the right of customer privacy through the need of previous consent
- Increased requirements to store customer information for potential future investigation by Government agencies

High discretionality awarded to NRA's for the transposition of directives into their respective national regulatory frameworks

... WITH POTENTIALLY MAJOR IMPLICATIONS BOTH FOR WIRELINE AND WIRELESS OPERATORS



NOT EXHAUSTIVE

Wireline

- Opening of additional incumbent's network elements (e.g., network management systems, billing systems, etc.)
- Potential limitation on incumbent's pricing regulation
- Limited regulation of emerging businesses (e.g., xDSL)
- Revision of various topics regarding Universal Service (financing, affordable price, ...)

Wireless

- Opening of dominant operators' networks to MVNOs at cost-oriented, regulated prices
- Potential creation of a secondary market for spectrum
- Redefinition of procedures for new spectrum assignments
- Application of wireline-type regulation to wireless, based on the principle of technological neutrality
- Regulation of network sharing
- Limited regulation of emerging businesses (e.g., wireless data)

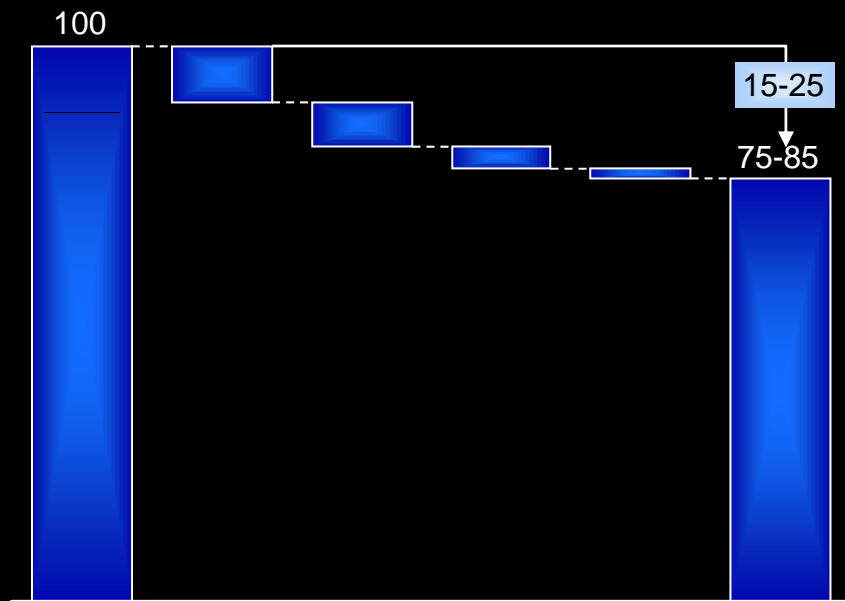
THE TRANSPOSITION OF EU DIRECTIVES TO NATIONAL REGULATORY FRAMEWORKS COULD HAVE SIGNIFICANT IMPACT ON INDUSTRY ECONOMICS...



Entity value. Percentage. Base 100

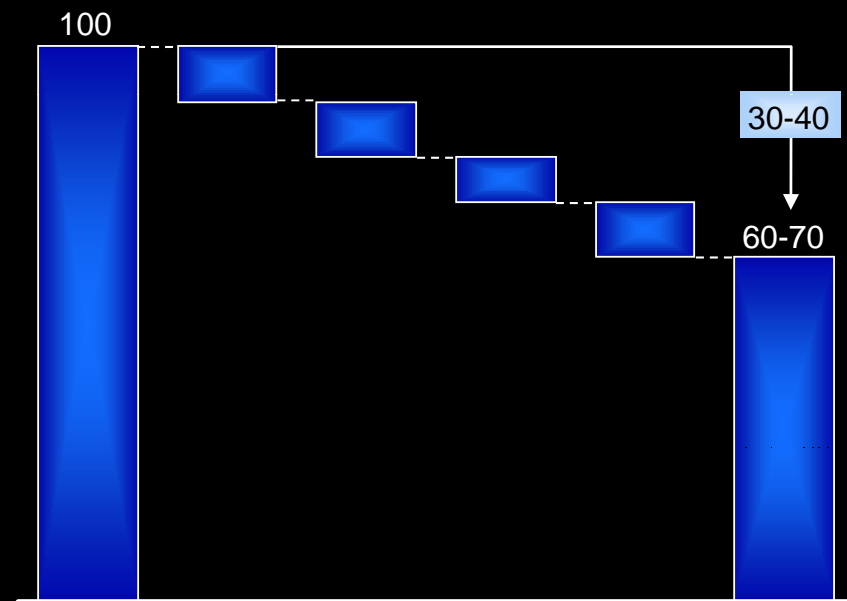
EUROPEAN
INCUMBENT

Wireline business unit



Best case scenario Opening of additional network elements Retail pricing regulation Regulation of emerging markets Others Worst case scenario

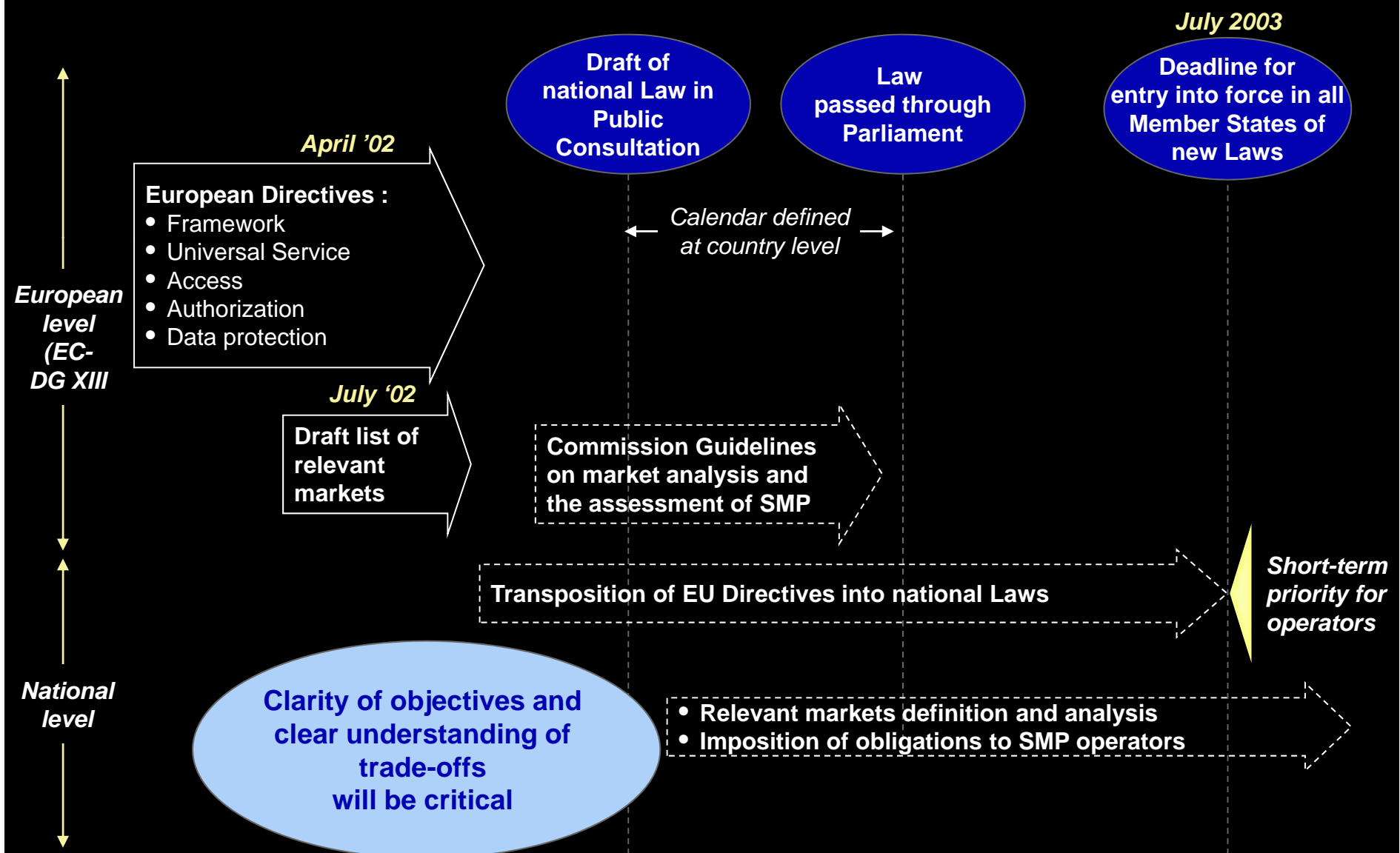
Wireless business unit



Best case scenario Entrance to MVNOs Regulation on spectrum Cost-oriented termination on prices Others (roaming, network sharing, etc...) Worst case scenario

NRAs must be careful about clearly understanding the potential trade-offs involved in implementing the new regulatory framework

...AND WILL REQUIRE SIGNIFICANT WORK IN THE COMING YEAR



IN DEVELOPING THE NEW REGULATORY FRAMEWORK IT IS CRITICAL THAT KEY CHALLENGES ARE ADDRESSED



Success in liberalization

- Effective competition
- Market development
- Service innovation
- High levels of investment

New challenges

- Growth slowing down
- Financing problems
- High investing needed to continue innovation

- Is the current industry structure viable?
- Is regulation creating a chronically under-performing sector?
- Are consumer benefits brought about by market liberalization sustainable?
- What impact will financial pressures have on innovation?

Key requirements for the new regulatory framework

- Reduce uncertainty in the industry
- Support business viability
- Foster growth and innovation by creating incentives for investment in infrastructures and services
- Ensure effective competition in the long-term
- Maintain customer benefits