



INTERCONNECT COMMUNICATIONS

A Telcordia Technologies Company

The Effect of Regulatory Obligations on the Incumbent Operator

Partnering for Success



Fintan Healy

InterConnect Communications

Written and published by: InterConnect Communications Ltd
Merlin House
Station Road
Chepstow
Monmouthshire
NP16 5PB
United Kingdom

Telephone: +44 (0) 1291 638400
Facsimile: +44 (0) 1291 638401
E-mail: info@icc-uk.com
Internet: <http://www.icc-uk.com>

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Introduction

Over the past two decades, the landscape of the electronic communications industry has changed almost out of all recognition. The liberalisation of electronic communications markets, fuelled by a variety of drivers including political choice, accession to multi-national trade agreements, technological developments, service diversity and the costs of onward investment relative to likely revenue returns, has shifted the game from one dominated by a small number of state-owned monopolies to a more competitive structure where a panoply of infrastructure and service providers compete for business across a variety of service sectors.

An essential adjunct to (and facilitator of) the development of liberalised markets has been the creation and development of suitable regulatory regimes and structures. As with liberalisation itself, the need for regulation stems from a variety of drivers, principally the need to foster effective competition given the de facto monopoly of the incumbent, the need to ensure the maintenance of essential services and the requirement to exert effective control over the use of scarce or finite resources. In addition, the unique characteristics of utility markets compared with many of their commercial equivalents require the application of specialist knowledge and experience that may not be readily available within the wider ranks of the national legislature or judiciary.

The inescapable outcome of this is that, whilst liberalisation has undoubtedly increased opportunities for all, incumbents in particular have had to adapt to a new set of circumstances posing both commercial and legal challenges. This paper aims to explore some of the ways in which regulatory obligations can affect the competitive position of incumbent telecommunications operators and how incumbents can draw on external partnerships to respond to those challenges whilst assuring ongoing success in their chosen market sectors.

Establishing Regulation

In virtually all liberalising markets, it is accepted that the introduction of competition into the telecommunications sector calls for the establishment of an independent regulatory body.

Various models and benchmarks exist for this, including the recommendations set out in the *Reference Paper on Regulation* appended to the World Trade Organisation's Agreement on Telecoms Services. Whilst the precise remit of a communications regulator varies from country to country, most are tasked with meeting a mix of technical, public policy and economic regulatory goals. For example, OFCOM, the United Kingdom regulatory body with responsibility for the communications industry, cites its core objective as being to further the interests of citizen-consumers as the communications industries enter the digital age, by:

- Balancing the promotion of choice and competition with the duty to foster plurality, informed citizenship, protect viewers, listeners and customers and promote cultural diversity;
- Serving the interests of the citizen-consumer as the communications industry enters the digital age;
- Supporting the need for innovators, creators and investors to flourish within markets driven by full and fair competition between all providers;
- Encouraging the evolution of electronic media and communications networks to the greater benefit of all.

Typically, the vision of governments and regulators for a liberalised telecommunications environment will be centred on the concept of a free and equitable market (the so-called

‘level playing field’) that meets both commercial and social demands whilst requiring minimum regulatory intervention. In most cases, however, this must be viewed as a long-term objective, progression towards which must be encouraged and secured through a series of overt regulatory measures designed to foster the development of competition without endangering market stability.

In the first instance, therefore, the regulatory stance will be one of simulating the effects of competition to facilitate market entry by new players whilst requiring the established incumbents to service social obligations which may not in themselves offer attractive financial returns. This gives rise to asymmetric regulation, which employs a measured degree of bias in favour of new entrants over incumbents in order to help them overcome the disadvantages imposed by the high costs of market entry and the incumbents’ entrenched position. The practical mechanism most usually used to achieve this end is the imposition of regulatory obligations on the incumbent, some of which we shall now review.

The Nature of Regulatory Obligations

Regulatory obligations upon incumbent operators may be imposed in a range of diverse areas and by various mechanisms.

Some of the core requirements (and, by the way, as set out in the WTO’s *Reference Paper*) relate to the interconnection of networks and traffic. In order to facilitate effective competition, regulators usually demand that incumbents set out transparent and non-discriminatory terms governing the provision of interconnection services to competitive operators. These must receive regulatory approval and be published in the form of a Reference Interconnection Offer or RIO, which is then used as a basis for individual agreements with interconnecting operators. Incumbents must also formulate a variety of procedures for dealing with other operators, the precise form of which may also be subject

to regulatory approval. These may include (but are not necessarily restricted to) procedures for negotiating interconnection, ordering and provisioning interconnect capacity and resolving any disputes that may arise. Last but not least, given the requirement to have interconnect charges and tariffs that are directly related to the costs of provision, incumbents will need to devise and implement procedures to calculate these costs in line with the regulator’s preferred practice and justify their interconnection tariffs accordingly.

Tariff regulation is not generally limited to interconnection, however, and usually seeks to influence the charges levied on consumers as well. Incumbents are likely to find themselves subject to regulatory obligations such as price-cap mechanisms that seek to limit price increases within certain limits (or even, in some cases, drive prices down). The objectives of such measures are varied, but generally encompass a regulatory desire to encourage improved operating efficiency on the part of the incumbent and a reflection of this in lower charges for users. Other rationales behind tariff regulation include the elimination of cross-subsidies between various services and activity types (‘rebalancing’), the protection of vulnerable user groups from price increases which might otherwise deny them access to telecommunications services, and the promotion of sustainable competition.

Consumer interests may also be served through the imposition on the incumbent of various other regulatory obligations, including the provision of approved contracts for service provision, the provision of information to customers (e.g. service conditions, itemised billing), data protection, minimum standards or targets for Quality of Service, and the implementation of agreed standards and procedures for matters such as dispute resolution and compensation.

Like interconnection, the question of access to facilities and services is also fundamental to the realisation of a competitive telecommunications market. In order to ensure that all entitled parties are able freely to participate in the market, regulators are likely to impose a range of

obligations, spanning both retail and wholesale areas of incumbent's business. At the retail (or customer-facing) level, regulatory obligations are likely to revolve around the concept of universal access, from the provision of public payphones through tariff regulation in the interests of affordability to the imposition of a Universal Service Obligation (USO) requiring the incumbent to provide basic services under agreed conditions to anyone requiring them. From the wholesale perspective, various measures designed to promote ease of market entry for challenger operators may be mandated, including the interconnection provisions detailed above, the unbundling of local loop circuits, collocation of switching facilities on the incumbent's premises and the sharing of other facilities such as rights of way, cable ducts, transmission masts, etc.

The allocation and management of scarce or finite resources is another area where regulators may feel it necessary to impose specific obligations upon the incumbent, especially if the incumbent continues to be the effective controller of those resources. Examples include the control of and non-discriminatory access to numbering resources (including the implementation of appropriate carrier selection and number portability provisions), radio frequency spectrum, subscriber lists for Directory Enquiry (DQ) purposes and network-related attributes such as rights of way, collocation facilities, etc.

Lastly, the issues of fair competition and the ability of incumbents to exert undue influence on the market are both important and emotive, and frequently the focus of regulatory obligations intended to speed the practical achievement of the 'level playing field'. In many markets, not least those in Europe, incumbents and others deemed to exercise 'Significant Market Power' (SMP – a measure of the operator's dominance based on its share of a particular market segment) are likely to find themselves subject to specific regulatory obligations relating to interconnection, universal service and other issues. In this area, regulatory oversight may not be restricted to the telecommunications regulator, with national competition and consumer protection bodies likely to impose their

own requirements and limitations. Intervention by competition authorities is especially likely in matters of ownership (especially where a single entity controls several players with competitive or related areas of activity), product and service bundling, discounts (especially those on wholesale services supplied to the incumbent's own downstream subsidiaries and affiliates) and retail pricing levels where these are so low as to be judged anti-competitive. This trend of regulation by a general competition regulator as opposed to a communications-specific one is widening and likely to continue as the number of market-influencing factors unique to telecommunications continues to decline.

The Likely Impact of Regulatory Obligations on the Incumbent

It must be stressed that aim of regulatory obligations is not to penalise the incumbent as such, but rather to secure social objectives and equalise the competitive position of incumbents and new entrants in the marketplace. Where it can reasonably be argued that a particular market is characterised by an effective level of competition, it would be difficult if not impossible to justify any number of regulatory obligations enforced against particular operators only.

In reality, however, many markets are not yet considered to be fully competitive, and the imposition of regulatory obligations can significantly impact incumbents, and not always for the better. The reasons for this are severalfold, not least the fact that the incumbent will be perceived (correctly) as dominant in many areas, especially fixed-line networks and local access. Where this is the case, or where the incumbent controls key assets such as network elements or other operational resources, the imposition of asymmetric regulation favouring new entrants is likely to be regarded as a precondition for effective competition. In addition, due to their size, market position and control of established networks, incumbents are most likely to be regarded as the natural candidates to support socially-oriented obligations such as universal service, provision of payphones and DQ services

etc, regardless of profitability.

Whilst it is undoubtedly correct to say that incumbents are usually better-placed to meet the demands of social obligations than are new entrants, it is equally true that a newly-liberalised market requires a certain degree of pragmatism on the part of regulators with regard to apportioning such responsibilities. Although an established incumbent is unlikely to desert its home market over the continuance of existing responsibilities, new entrants are likely to take a far more cautious approach and may well decline to enter new markets where regulatory obligations are felt to be too onerous. Conversely, it is true to say that properly-financed challengers with a well-reasoned business plan can benefit considerably from their freedom to target particular markets without having to support the legacy and regulatory obligations borne by incumbents, as is witnessed by the continuing migration of basic voice traffic from fixed-line to mobile services. In this vein, many incumbents are concerned that market convergence may see challengers achieving significant share in areas such as voice-over-Internet (VoIP) traffic without having to assume equivalent responsibilities (e.g. USO).

A less obvious (but still significant) burden for incumbents is that stemming from the increased levels of management and administrative effort required to service regulatory-mandated procedures and demonstrate ongoing compliance with obligations relating to quality of service, data protection, accounting separation, etc. Unlike social obligations, the costs of which may sometimes be defrayed (at least in part) by grant mechanisms or charges on other market players, compliance activities have to be regarded as a cost of business and absorbed accordingly. This may be particularly onerous given the inevitable dichotomy between social/regulatory responsibilities and shareholder/market pressures, which may be greater for a publicly-quoted incumbent than for a wholly-owned challenger where investors are prepared to trade short-term profits for long-term market share.

Last but not least, it is worth considering that regulatory authorities may well have ulterior motives in applying some if not all regulatory obligations. There can be no doubt that some regulatory positions reflect higher policy objectives from central or regional government (i.e. the use of Local Loop Unbundling to promote a broadband-based 'knowledge economy'). Likewise, many regulators (not just in telecoms) take the view that, once monopoly-era market anomalies have been eliminated, incumbents tend to constitute opinion leaders and models for the rest of the industry. On this basis, early moves to make the incumbent conform with the regulator's own vision for development of the market are likely to pay dividends in terms of influencing other players later on.

Transformation - Response through Partnerships

Perhaps key to minimising the negative impact of regulatory obligations is for the incumbent to understand the precise nature of the requirements upon it, then build and maintain a constructive relationship with the regulator. As we have seen, the regulator is tasked with the creation and development of a competitive market serving a broad range of economic, political and social interests. Even under the principle of asymmetric regulation, the incumbent remains an essential partner and facilitator in this process, in terms of supporting obligations such as universal service and providing a model for other market entrants to follow. It is seldom, therefore, in the interest of the regulator to apply obligations that are disproportionately harmful to the incumbent, though political pressures can occasionally tip the balance in this regard.

Whilst the ideal to which both regulator and incumbent should strive is one of a symbiotic relationship, this does not preclude the incumbent seeking to take the initiative on regulatory issues wherever possible. By understanding regulatory trends, anticipating likely actions and requirements and reflecting these in its own strategy, the incumbent can embrace

developments and secure for itself a non-adversarial relationship with the regulator. At the same time, it can use this input to ensure that the regulator understands the incumbent's position on key issues and reflects this in policy decisions. Indeed, to recall the dictum that 'attack is the best form of defence', it can even be suggested that incumbents may wish to consider pre-empting potentially damaging obligations by suggesting alternatives which satisfy regulatory objectives whilst remaining attuned to the incumbent's own corporate direction and goals, though care would have to be taken not to compromise the regulator's impartiality in this regard.

The primary mechanism for achieving this must be an effective and proactive regulatory affairs function within the incumbent, capable of matching the skills of the regulatory body and maintaining an ongoing liaison with it and other interested parties. Other essential attributes will include the development of effective links with all parts of the company to ensure ongoing compliance and provide a means for operational issues and concerns to be elevated to a regulatory level. Finally, it must be able to monitor economic, market and political developments in order to anticipate likely regulatory actions and provide evidentiary support to the incumbent's own position.

Whilst this sort of institutional capability building is both a practical necessity and a good investment, it is recognised that the commitments involved can prove a major burden for a range of incumbents. Newly-liberalised operators are likely to find themselves facing significant shortfalls in relevant skills and experience, whilst even established players may find it difficult to support the resulting calls on management resources where they are engaged in highly competitive markets with tight margins. By engaging a suitable external partner, incumbents at all levels can access the expertise, knowledge and skills required to boost regulatory capability whilst leaving management free to concentrate on the running of the core business.

The extent and nature of this partnership will depend very much on the circumstances of

the incumbent involved, as can be illustrated from various examples in the experience of InterConnect Communications and its parent company, Telcordia Technologies Inc. For an incumbent in a newly-liberalising market, the primary requirements revolve around understanding the regulatory model to be applied, the resulting obligations upon market participants and the likely effects upon their activities. In such cases, a process of consultation with regulatory experts can deliver significant value to the incumbent by identifying how the different aspects of the new regime will impact their business, the responses that need to be made and the most effective means of making these. In Egypt, InterConnect assisted the incumbent to prepare for increased market liberalisation and to operate under the control of an independent regulator with enhanced powers by developing a suitable regulatory policy and advising on relationship-building with the regulator. Similarly, in Ghana, advice was given to the incumbent on how it should restructure itself in order to prepare for privatisation and liberalisation of the telecommunications market.

Another challenge for developing incumbents is in assimilating the technical knowledge and skills required to fulfil many of their new regulatory obligations. For instance, the writing and structuring of a Reference Interconnection Offer and the supporting guidelines and processes may prove a considerable challenge to an operator with little if any experience of implementing interconnection in a liberalised market. Use of an external partner with specific experience in this specialism can significantly ease this process, and InterConnect is currently aiding the Saudi incumbent not only to construct a RIO in line with regulatory requirements, but also to establish a suitable carrier services department to handle its relationships with other interconnecting operators. Established incumbents too can find themselves in need of specialised technical assistance where new obligations such as local loop unbundling (LLU) are introduced, InterConnect having recently assisted the Maltese incumbent with the development of a Reference Unbundling Offer (RUO) including service definition, costing, surveying relevant

network facilities and preparation of the requisite commercial and technical processes. In Oman, InterConnect has helped the incumbent define suitable Service Level Agreements (SLAs) whilst in Latvia, we assisted the incumbent to identify a series of benchmarks for service quality and network performance, based on international best practice, then develop processes to move from its current performance to the new targets.

Another area in which incumbents at all levels may require specialised regulatory assistance is in the area of accounting separation and cost allocation. Incumbents will need to demonstrate to the regulator that their tariffs (both wholesale and retail) are objectively justified, usually on the basis of a Long-Run Incremental Cost (LRIC) or similar model, and that accounting practices are effective in apportioning costs to the specific areas of activity responsible for incurring them. Over the years, InterConnect has provided assistance to a variety of incumbents in this regard, notably the definition of services and development of appropriate accounting separation and cost allocation practices in the Czech Republic, the Gambia and Oman, the use of a LRIC cost model to determine the costs of interconnection for submission to the regulator in Saudi Arabia, and the justification of the incumbent's interconnect tariffs before the regulator in Botswana. InterConnect has also developed software models to facilitate the analysis of cost bases in both fixed-line and mobile networks, these having been supplied to users in a range of global markets.

Lastly, it is vital not to underestimate the importance of understanding and benchmarking international trends and best practice solutions in the sphere of regulatory obligations. As well as allowing incumbents to anticipate regulatory requirements and offer solutions to these that minimise adverse effects upon the business, the intelligent use of best practice examples offers a powerful tool to help justify actual and proposed courses of action. Knowledge transfer in this manner is yet another means by which an external partner can assist incumbents respond to regulatory actions, InterConnect having

provided background data and analyses from other markets to assist operators in markets as diverse as Botswana, Israel and Poland justify their activities and influence regulatory proposals that might otherwise have exerted a negative effect on their businesses.

Conclusion

Regulatory obligations are undoubtedly a necessary component of a liberalising market. Without them, it is impossible to create the conditions necessary to foster new competition without the risk of market instability and possible damage to amenities and services deemed to be of wider social importance. For incumbents, however, they can exert a rather less benevolent influence in terms of placing them under regulatory pressure to take actions that are at variance with their commercial and operating objectives.

Incumbents can best deal with this threat by quickly achieving a full understanding of the regulatory issues and pressures that they face and implementing relevant strategies in response. These should aim not just to ensure compliance but also to engage positively and constructively with the regulator so as to optimise the extent to which regulatory actions recognise the commercial and operational realities facing the incumbent. The successful attainment of these goals is key to maintaining market position and profitability.

By involving proven experts at an early stage, incumbents at all levels can access the skills and knowledge necessary to implement a coherent and effective regulatory response and planning function without placing undue burdens upon the management structure or operational activities of the company. The result will be the rapid attainment of a regulatory capability able to mitigate the majority of challenges to the incumbent's business or even turn them into a win:win situation for both parties. For this reason, it is imperative to view regulatory functions as an integral component of any transformation strategy.

About...

The Author

Fintan Healy is Director of Legal & Regulatory Services at InterConnect Communications Ltd. Fintan, who has worked for InterConnect since 1989, is a lawyer specialising in the legal and regulatory aspects of the communications sector. He has a Post Graduate Diploma in Law, a Certificate of Academic Achievement from the Law Society of England and Wales in addition to an HND in Telecommunications and Electronic Engineering. He has advised Governments in the drafting and adoption of Acquis compliant laws, regulations and regulatory regimes and has drafted licences and interconnection agreements in support of pro-competitive regulatory environments. He lectures widely on regulatory matters.

Fintan may be contacted on +44 1291 638400 or e-mailed at fintanhealy@icc-uk.com

InterConnect Communications

InterConnect Communications is a wholly-owned subsidiary of Telcordia Technologies Inc., based in the United Kingdom. InterConnect provides a matrix of regulatory, commercial and technical professional services which are offered to a customer base covering network operators and other service providers, governments, regulators and international bodies (such as the European Union and World Bank).

Principal services offered to network operators and other service providers include:

- Business planning and strategy;
- Technical due diligence;
- The application and implications of international, regional and national laws and regulations;
- Cost base analysis and control;
- Traffic analysis and network optimisation;
- Tariff setting for retail and wholesale business;
- Assistance with the commercial aspects of network interconnection;
- The provision of consulting and software models.

For more details of InterConnect's services, please visit our website.



**Merlin House, Station Road,
Chepstow, Monmouthshire, NP16 5PB.
United Kingdom**

Telephone: +44 (0) 1291 638400
Facsimile: +44 (0) 1291 638401
Internet: <http://www.icc-uk.com>