FUNCTIONAL SEPARATION IN EUROPE

THE SWEDISH MODEL

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Access problems in Sweden have led the Swedish government to propose a bill of functional separation well ahead of the parallel process in the European Union. The proposed bill is a framework for imposing functional separation on an operator and does not answer, although implies affirmatively, whether functional separation actually should be imposed in Sweden. A related question is if functional separation could lead to a reduction in and help the removal of sector regulation. Structural measures have been used in general competition law to improve competitive conditions and experience can be drawn from this.

During the last couple of years there has been a debate in many European member states over functional separation. Despite other access regulation in place there have been signs that the incumbent operators discriminate LLU operators as they don’t receive the same quality of service as the incumbents’ own downstream operations. In Sweden this debate has been quite intense and the separation of network ownership from sale of services to end users has been widely discussed over the years, although mostly in the form of structural separation. This has now led to a Swedish model of functional separation.

An inspiration for many member states is of course the voluntary commitments by BT of functional separation in the UK. In a way the Swedish model has many similarities with the BT model but Sweden has chosen a different approach for the implementation of functional separation. The Swedish government has proposed to amend the law in order to allow PTS, the Swedish National Regulatory Authority (NRA), to impose functional separation as a remedy on an operator and the model is in that aspect a framework for functional separation in Sweden. The Swedish model is closely matched with the European regulatory framework for electronic communications.

It is too early to say if functional separation will be implemented as a remedy in Sweden or not. But the remedy as such, with the aims to create equality between operators and increased transparency for operators and regulators, could be a means to reduce other forms of access regulation in the sector and speed up the process of removing all ex ante regulation. The experience of structural measures in general competition law should be looked at in this process.

REGULATORY CONTEXT – EX ANTE AND EX POST

Competition law and regulation apply simultaneously in the telecom sector. They do not conflict but instead may complement one another in several ways. Regulation, with its objective to promote competition, may liberalise uncompetitive markets or correct market failure. When competitive conditions have been established, competition law is intended to take over and maintain competitive conditions. Competition law as well as regulation is constrained by generally applicable principles of European law, such as harmonisation. The objectives of competition law are to prevent measures which restrict competition unjustifiably. Regulation, although its primary objective is to promote competition, can be designed to promote other objectives. Competition law could however also be used to achieve essentially regulatory objectives.

General competition law in Europe can be found in Articles 81 and 82 of the European Union Treaty, which are reflected in most member states’ national competition laws. Article 81
prohibits anticompetitive agreements and Article 82 the abuse of a dominant position in a particular market.

The provision of networks and services for electronic communications are in Europe regulated by the directives adopted by the European Union in this sector. The directives of particular significance for functional separation are the Framework Directive and the Access Directive. In addition, regulation consists of the European Commission (the Commission) guidelines on market analysis and assessment of significant market power and the Commission Recommendation on relevant product and service markets.

The European regulatory framework for electronic communication (the regulatory framework) has been implemented in Swedish law through the Electronic Communications Act. The Swedish NRA is the Swedish Post and Telecom Agency, PTS.

**IMPOSING FUNCTIONAL SEPARATION UNDER EUROPEAN COMPETITION LAW**

The main objective of competition law is to ensure an overall economic efficiency, and therefore its intervention is focused on the acquisition and the exercise of market power. Under European law, the main threshold for a competition authority to intervene is the presence of a level of market power equivalent to a dominant position, which has been defined as the position of economic strength which gives the power to behave to an appreciable extent independently of competitors, consumers and ultimately consumers.

Competition authorities control market power, and when necessary impose obligations to undertakings, in two ways - ex post under Articles 81 and 82 EC when anti-competitive agreements or abuses are committed by imposing fines, behavioural or structural remedies, and ex ante under the Merger Regulation by blocking a merger that would significantly impede competition or imposing remedies to remove any competitive concerns. As merger control is mainly about market structure, structural remedies should be preferred, but behavioural remedies may be accepted provided they have some sort of structural effects on the market.

There are numerous examples of structural measures under merger regulation, for instance in the Telia/Sonera merger where the Commission considered that the merger would strengthen the dominant position on several Finnish and Swedish telecom markets because of overlapping activities, loss of potential competition and the possibility to leverage market power from the mobile and fixed markets. Therefore, the Commission only cleared the merger after the parties agreed to divest any overlapping business, mobile and WLAN activities in Finland and cable TV in Sweden. In addition as the unbundling was not very successful to alleviate leverage from the local loop to other telecom markets, the Commission imposed a legal separation between the operation of networks and services of their fixed and mobile activities in Sweden and in Finland, as well as a non discriminatory access to fixed and mobile termination for three years with a fast track dispute resolution procedure.

Competition authorities can also impose structural remedies under article 81 and 82. Under Article 7 of Regulation 1/2003 EC on the implementation of the rules on competition laid down in Articles 81 and 82 of the Treaty the Commission may impose any behavioural or structural remedies which are proportionate to the infringement committed and necessary to bring the infringement effectively to an end. Structural remedies can only be imposed either where there is
no equally effective behavioural remedy or where any equally effective behavioural remedy would be more burdensome for the undertaking concerned than the structural remedy. Changes to the structure of an undertaking as it existed before the infringement was committed would only be proportionate where there is a substantial risk of a lasting or repeated infringement that derives from the very structure of the undertaking.

The threshold for imposing structural remedies under Article 81 and 82 EC is very high and the imposition of structural remedies will require exceptional circumstances. As the Commission, under Article 9 of Regulation 1/2003 EC, has the power to accept voluntary commitments, structural remedies might be offered voluntary by an undertaking. An example of this is the structural remedies offered by E.ON to settle ongoing antitrust cases in the electricity sector. E.ON proposes to commit to sell its electricity transmission system network to an operator which would have no interest in the electricity generation and/or supply businesses and to commit to divest 4800MW of generation capacity to competitors.

**IMPOSING FUNCTIONAL SEPARATION IN THE EUROPEAN REGULATORY SYSTEM**

The regulatory framework could be described as an ex ante regulation for the electronic communications sector. The regulatory framework intervenes with detailed and specifically adapted intervention to resolve typical and potential problems. A general aim of the regulatory framework is to promote competition. The long run ambition of the regulatory framework is a transition from sector regulation to general competition law.

**THE EC REGULATORY FRAMEWORK**

The imposition of any remedy under the regulatory framework is carried out in a three stage process. The first stage is the market definition. National Regulatory Authorities (NRAs) define markets susceptible to ex ante regulation, appropriate to national circumstances, taking the utmost account of the markets identified in the Commission Recommendation on relevant markets and the three criteria described to identify the markets which have the characteristics to justify the imposition of regulatory obligations – (i) high and non-transitory entry barriers, (ii) the dynamic state of competitiveness behind entry barriers and (iii) the sufficiency of competition law (absent ex ante regulation).

The second stage is the market analysis. Once a market is defined it must be analysed to assess the degree of competition on that market. NRAs should impose obligations on undertakings only where the markets are considered not to be effectively competitive as a result of such undertakings being in a position equivalent to dominance within the meaning of Article 82 EC. The notion of dominance has been defined in the case-law of the Court of Justice as a position of economic strength affording an undertaking the power to behave to an appreciable extent independently of competitors, customers and ultimately consumers.

The third stage is remedies. Where competition on the market is not effective and the NRA designates one or more operators as having SMP on that market, at least one appropriate ex ante remedy must be applied. Ex ante regulation should be imposed on defined markets having characteristics which may be such as to justify the imposition of ex ante regulatory obligations. Remedies imposed shall be based on the nature of the problem identified, proportionate and
justified in the light of the objectives. It is essential that ex ante remedies 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.

The standard remedies provided by the new regulatory framework are set out in articles 9 to 13 of the Access Directive and 17 to 19 of the Universal Service Directive. The wholesale obligations set out in the Access Directive are transparency, non-discrimination, accounting separation, access and price control and cost accounting. In addition, the Access Directive enables NRAs to impose remedies other than the standard remedies enumerated in the Directive in exceptional circumstances. It shall then submit a request to do so to the Commission, who shall take a decision authorizing or preventing the NRA from taking such measures.

What constitutes exceptional circumstances has never been defined by the Commission. As functional separation can only be imposed as a remedy in the current regulatory framework under exceptional circumstances, the Commission would have the power to prevent such a remedy if the criteria is not satisfied.

**THE EUROPEAN MODEL OF FUNCTIONAL SEPARATION**

The EC regulatory framework is currently undergoing a review. The Commission adopted its proposals\(^8\) for a reform on 13 November 2007. The proposals are the result of two years of consultations with stakeholders, with NRAs and with users of telecoms services. The proposals are now being debated in the European Parliament, and by Member State governments in the Council. Once adopted at EU level, the revised rules have to be incorporated into national law before taking effect. The Commission expects the new framework to be in place from 2010 onwards.

In the proposal for a new Access Directive functional separation is introduced as a remedy that can be imposed by NRAs, subject to approval by the Commission. The remedy is introduced as an additional remedy.

According to Article 13a of the proposed Access Directive an NRA may impose an obligation on vertically integrated undertakings to place activities related to the wholesale provision of access products in an independently operating business unit. That business unit shall supply access products and services to all undertakings, including other business units within the parent company, on the same timescales, terms and conditions, including with regard to price and service levels, and by means of the same systems and processes.

When a national regulatory authority intends to impose an obligation for functional separation, it shall submit a request to the Commission that includes, among other things, evidence that the imposition of appropriate obligations amongst those identified in Articles 9-13 to achieve effective competition following a co-ordinated analysis of the relevant markets has failed and would fail on a persistent basis to achieve effective competition, and that there are important and persisting competition problems and market failures identified in several of these product markets. Such a request should also include the nature and level of separation, legal status of the separate business entity, identification of the assets of the separate business entity, and the products or services to be supplied by this entity, arrangements to ensure the independence of the staff employed by the
separate business entity, rules for ensuring compliance with the obligations, rules for ensuring transparency of operational procedures, and a monitoring programme to ensure compliance.

In addition to the remedy the Commission also introduced voluntary separation by a vertically integrated undertaking, whereby an undertaking which have been designated as having significant market power shall inform the NRA if they intend to transfer their local access network assets to a separate legal entity under different ownership, or to establish a separate business entity in order to provide to all retail providers, including its own retail divisions, fully equivalent access products.

ARGUMENTS FOR FUNCTIONAL SEPARATION IN EUROPE

The Commission, although initially seemingly reluctant towards functional separation, have put forward many arguments for functional separation as a remedy in the regulatory framework in the process of reviewing the regulatory framework.

In a joint statement\(^9\) of commissioner Viviane Reding and Roberto Viola, chairman of the European Regulators Group (ERG) on February 27\(^{th}\) 2007 the Commission (and ERG) opened up the possibility of including some form of vertical separation in the new regulatory framework due to take effect in 2010.

In a speech\(^10\) on March 5\(^{th}\) 2007 Viviane Reding expressed concerns over harmonisation problems and the fact that there is no internal market in the electronic communications sector and that the reason for this is mainly a regulatory one. The market conditions vary between member states, but inconsistencies in regulatory approaches are exacerbating these divergences: inconsistencies in the speed of implementation of the rules; in the appeals procedures and also in the remedies applied. As a policy implications Reding puts forward separation as a mean to achieve more competition. To promote equality of access Reding means that NRAs should have a new remedy in their toolbox: the legal separation of the network assets from the service layers. Functional separation would not go as far as full divestiture, but it would create a clear dividing line between the part of the organisation that is managing the network and the part that is competing with the other operators using the network.

In a speech\(^11\) on March 21\(^{st}\) 2007 Viviane Reding further clarified the case for vertical separation in the form of ‘functional separation’ or ‘the separation within the business of the management of the infrastructure provision from service provision’. According to Reding this could be a good regulatory solution where there would be no economic case for infrastructural competition due to the high costs of rolling out new networks. In particular this may be a solution to problems of discrimination between the incumbent’s services and the services of its competitors. A solution has to be transparent and provide appropriate incentives to offer innovative services on a non-discriminatory basis.

From the impact assessment\(^12\) to the directives there is clear support for functional separation as a new remedy. The Commission considers it necessary to provide NRA’s with the power to impose functional separation as an exceptional remedy aimed at tackling persistent discrimination, not addressed through the existing set of behavioural remedies.

In the impact assessment the reason for proposing functional separation is described as a remedy to ensure the provision of fully equivalent access products to all downstream operators by significantly reducing the incentive for discrimination and by making it easier for compliance
with non-discrimination obligations to be verified and enforced. Commission stresses the importance of preserving investment incentives and to prevent the negative effects on consumer welfare. The Commission also points out that the implementation of functional separation should not prevent appropriate coordination mechanisms between the different separate business entities.

It is important to bear in mind that the proposal from the Commission is a proposal of a ‘last resort remedy’ to be imposed only under exceptional circumstances or as the Commission puts it: ‘In exceptional cases, it may be justified as a remedy where there has been persistent failure to achieve effective non-discrimination in several of the markets concerned, and where there is little or no prospect of infrastructure competition within a reasonable timeframe after recourse to one or more remedies previously considered to be appropriate’. All proposals for functional separation should therefore be approved in advance by the Commission.

**THE SWEDISH MODEL OF FUNCTIONAL SEPARATION**

The background of the law proposal was a report, Broadband in Sweden 2006, presented by PTS on 15 June 2006 where the problems in the broadband sector were described - that a substantial number of Swedes still lack access to a broadband network, while almost half of residential broadband customers have no freedom of choice. In a more thorough study, ‘Proposal for Swedish Broadband Strategy’, was presented 15 February 2007 where PTS in more detail looked into the problems. In this report one fundamental competition problem was that the buy-sell relationship was not functioning between TeliaSonera and the undertaking’s wholesale customers. This situation impedes Sweden’s potential as an IT nation, and has, for example, resulted in Sweden falling behind our Nordic neighbours.

A new model for the equal treatment of operators that require access to TeliaSonera’s fixed local loop in order to offer broadband services was discussed. PTS came to the conclusion that the most appropriate model would be a functional separation of TeliaSonera. PTS simultaneously concluded that PTS has no legal tools for implementing a functional separation. A statutory amendment was considered to be the quickest way in which to be able to compel functional separation.

**PROBLEMS IN THE SWEDISH MARKET**

According to PTS, the experience from their supervisory work shows that the market for access to TeliaSonera’s network is characterised by significant competition problems, despite ex ante regulation being in place. These problems often take the form of discriminatory behaviour, and it has been observed that TeliaSonera has an information advantage in relation both to other operators and PTS. The conclusion that is drawn is that access to TeliaSonera’s metallic loop does not represent a functioning marketplace, as there is a lack both of sufficient openness and equal treatment in this market. Several attempts have been made, both through regulation and general competition law, to rectify the problems related to access.

In an attempt to resolve the practical problems in the market, PTS initiated a voluntary dialogue between TeliaSonera and wholesale customers during the spring of 2007 with the aim of discussing the problems that exist in the LLU market. Confidence between the parties has grown, although distrust still prevails vis-à-vis the actions of other operators. This is a step in the right direction, but it is unclear whether it will resolve the problems in the market.
THE ASSIGNMENT

On 19 April 2007, PTS was assigned by the Government to, among other things, investigate the preconditions for and propose the formulation of legislation for the separation of a vertically integrated operator to promote non-discrimination and transparency in access to the local loop (LLU). According to the assignment, this remedy should aim to establish organisational separation and independent decision-making (vertical separation) within a vertically integrated operator, upon which LLU obligations are imposed, between, on the one hand, such operations that comprise the provision of networks and services at a wholesale level and, on the other hand, the operations that comprise the sale of services provided to end users through such networks.

It is stated in the assignment that an obligation to implement vertical separation should be linked to the obligations imposed under Chapter 8, Section 6 and Chapter 4, Section 4 of the Electronic Communications Act, which include access on non-discriminatory terms to such a network as referred to in Chapter 4, Section 9 of the same Act. The function to be separated from other functions should concern the operation, maintenance and provision of primarily those parts of the network to which the obligations refer. It should be noted that the separated function may also be of significance to the provision of other wholesale services regulated under the Electronic Communications Act; for example, access to wholesale line rental (WLR).

According to the assignment, PTS should also, besides reporting the matters referred to above, investigate the possibility of PTS accepting commitments including measures from a vertically integrated operator upon which LLU obligations aimed at ensuring non-discrimination and transparency have been imposed, and propose the regulation necessary for doing this. Other legal solutions may also be reported as alternatives.

The assignment includes PTS consulting with the Swedish Competition Authority on competition law issues. It is stated that PTS shall report on this assignment no later than 15 June 2007 and that the proposed regulation should contain a draft of the statutory wording.

PTS PROPOSAL

In the report ‘Improved broadband competition through functional separation - statutory proposal for non-discrimination and openness in the local loop’ PTS proposed that the ability of the NRA to impose functional separation on a dominant stakeholder should be introduced, meaning that the parts of the operation representing bottleneck resources should be separated from the rest of the organisation. PTS proposal was in line with the assignment with some additional suggestions which I will come back to later on.

GOVERNMENTAL LAW PROPOSAL

On the 18 March the Government approved the Bill ‘Functional separation for better broadband competition’. It is proposed that the new provisions enter into force on 1 July. In the Bill, the Government proposes that PTS be given more scope to intervene so as to increase competition in the broadband market by ordering functional separation. According to the proposal, functional separation shall be introduced as an obligation in the Electronic Communications Act. Before obligations are introduced, a market analysis must be carried out as regards the relevant market(s)
in which it may be applicable to impose functional separation. Before a decision on obligations is made, a consultation must also be carried out and a notification submitted to the Commission.

The Government’s proposal means that if there are exceptional circumstances PTS can decide that a vertically integrated operator, who already has SMP on the LLU market, should organizationally separate those business units that administer, operate and supply the copper access network from other operations, particularly sales operations. The separation should ensure that all actors are given access on equal terms to the copper access network. The decision on functional separation could also include bitstream access. The proposal can never mean that the dominant operator, today TeliaSonera AB, will be forced to transfer ownership of the copper access network to a special company.

To ensure that the separated business unit is independent in relation to the operator’s other activities, PTS can decide on terms that limit influence over the separated unit. Such terms could be that the operator’s influence is limited through organizational measures or requirements that the business units should be managed by separate legal persons. PTS could also require independence of management. It will also be possible for the PTS to order the dominant operator to ensure that it has a function that monitors compliance with its obligation.

The proposed Act will also give the dominant operator, with SMP on LLU and bitstream markets, the alternative option of implementing functional separation voluntarily by committing to separate the access network related to these markets. A voluntary separation of this kind can be approved by the PTS in a decision only if there are exceptional circumstances.

ARGUMENTS FOR FUNCTIONAL SEPARATION IN SWEDEN

As in other solutions of functional separation in Europe and elsewhere, the Swedish model contains two parts – one structural part where the structure of the operator is changed and one behavioural part where behavioural measures are added to support the usually complex structural measure inherent in solutions of functional separation.

One should bear in mind is that arguments in the PTS proposal as well as in the government proposal are arguments for a new regulatory tool and not imposition of functional separation on the Swedish market, even if this is implied. The arguments are similar in the proposals. The importance of LLU and bitstream access is stressed. Experience from PTS supervisory work shows that the market for access to TeliaSoneras metallic loops is characterised by significant competition problems despite there being ex ante regulation in the sector. PTS has also observed similar competition problems in the bitstream access market. The problems often manifest themselves in the form of discriminatory behaviour. The conclusion that is drawn is that access to TeliaSoneras metallic loops is not a functional marketplace as it lacks both sufficient transparency and equal treatment. Several attempts have been made to rectify these access-related problems by means of sector regulation and competition legislation, but without achieving any satisfactory result.

COMMENTS ON THE SWEDISH MODEL OF FUNCTIONAL SEPARATION

The PTS proposal and the government law proposal are of course very similar. There are some differences that might have an impact on the implementation of functional separation in Sweden. One difference is that the law proposal stipulates that PTS can only impose the remedy of func-
tional separation if there are extraordinary circumstances, which means that the criteria extraordinary circumstances could be scrutinised in national courts as well as in the Commission.

There are also important differences between the Swedish proposals – PTS proposal and government law proposal – and the Commission proposal. According to the law proposal a remedy of functional separation can only be imposed on an undertaking already having an access obligation to a public telephone network, comprised of a twin cable of metal, between a main distribution frame or a similar interconnection point and a subscriber's fixed network termination point. This limits the scope of the remedy considerably by, for the time being, excluding fibre infrastructure. This limitation was already present in the assignment to PTS.

CONCLUDING REMARKS

The Swedish model of functional separation is similar to other models of functional separation in Europe, in particular the UK model and the proposal of functional separation in the review of the directives for electronic communications. The differences I have stressed might be of minor importance. However, I believe it would be a good idea to have a common European understanding of functional separation and a harmonised approach. This has already been achieved to some extent through discussions between the Commission, NRAs and the ERG. Some differences must be allowed at a member states level depending on particular national circumstances.

There will of course be difficult assessments at the member states level whether implementation of functional separation would improve anticompetitive conditions and if an implementation is proportional to the problems. And even if you answer yes on these questions it will be difficult and time consuming to decide on where to separate, bearing in mind also the positive effects of vertical integration and the costs of the actual separation. A voluntary solution, like the one we have seen in the UK is definitely to be preferred. The Swedish model also opens up the possibility of a voluntary solution.

An interesting question to ask is whether structural remedies, such as functional separation, would help the process of deregulation and the transition from sector regulation to general competition law. The continuing improvements of the competitive situation within Europe will lead to deregulation within the telecommunications sector, but in some markets the process might be very long. Structural measures, taking into account the particular characteristics of the sector, the benefits of vertical integration and the investment incentives could be a solution.

Functional separation is structural and does not need to entail any additional regulation for the operator. Instead, functional separation aims to create such openness for NRAs and other operators that the requirements on non-discrimination ensuing from existing remedies can be realised, which is to underpin the existing behavioural remedies or non-discrimination requirements under general competition law. Functional separation may create incentives for the market to establish a functioning buy-sell relationship, which would eliminate the incentive to discriminate and thereby promote competition.

The experience of structural measures under competition law could give assistance to the process of implementing functional separation, especially the vast experience in Europe to deal with mergers where structural remedies are common. Preferably the solution should be voluntarily, that it is suggested by the operator concerned. As in merger cases the operator concerned should have incentives to suggest a solution to avoid the alternative.
ENDNOTES

4. Commission guidelines of 11 July 2002 on market analysis and the assessment of significant market power under the Community regulatory framework for electronic communications networks and services.
11. Speech by Viviane Reding; Colloquium Vers une société de l’information dynamique en Belgique, Telecommunications Markets in Europe: Growth and Investment need competition, 10th General Assembly of the Belgian Platform Telecom Operators and Service Providers, 21 March 2007, Brussels.