



Final Report

Comparative Study on Economic Regulation in Certain EU Member States

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1 INTRODUCTION AND CONCLUSIONS

- 1.1 This is a Final Report to FICORA on a comparative study on economic regulation in five EU Member States.

Objectives of the Study

- 1.2 The purpose of the study is to provide an overview of experience of economic regulation of telecommunications operators in Denmark, Ireland, Italy, Sweden and the UK on a range of issues of most interest to the situation in Finland, and to review the conclusions of the European Commission regarding the transposition of the EC regulatory framework with regard to economic regulation.
- 1.3 The findings will be used to inform FICORA on how to develop its own procedures in the field of economic regulation given the market structure and other specific national circumstances in Finland, and to advise on eventual propositions on the development of legislation and ex-ante regulation in Finland.

Summary of Findings

- 1.4 This study does not comment on the need for specific regulatory solutions. These will be determined by the policy objectives of the European Commission and FICORA's own policy objectives. They will also follow from the market reviews conducted by FICORA. However, the study does put forward a series of propositions regarding the types of tools and powers that would assist FICORA to become a more effective economic regulator given those objectives and the findings of the market reviews.
- 1.5 The main finding of this report is that FICORA does not have the powers that it should have — and needs to have — in order to regulate effectively. The review of economic regulation in the five EU Member States confirmed this fact and highlighted that regulatory authorities in those Member States do have a wider range of tools available to them.
- 1.6 The transposition of the new EC Directives also appears to be incomplete and as a consequence, FICORA do not have the legal powers to give effect to some of the main Articles in the Access Directive (such as the obligation to impose cost accounting systems and to adjust prices).
- 1.7 Some of the main propositions in this report include:
- (a) A body with experience of legal, regulatory and communications issues should be created in order to hear appeals against any of FICORA's decisions. Unless there are compelling reasons, FICORA's decisions should stand during these appeals.
 - (b) The market structure in Finland — in particular, the large number of operators with SMP — could create opportunities to strengthen regulation. We recommend that information on prices and costs of a wide range of regulated services be produced in a comparable manner. This would encourage “yardstick competition” and provide rich



data to FICORA, which it could use to develop a deeper understanding of the communications sector in Finland and to provide guidance as to where further investigation may be needed.

- (c) FICORA should be given a wider range of powers to set prices. These powers — which are set out in the Access Directive and which are used by other regulatory authorities across Europe — could be used in different circumstances to achieve the EC's and FICORA's objectives.

1.8 We note that Finland has a history of light-handed regulation of telecommunications and that such regulation is likely to be preferred going forward. If this is the case, however, it is still important that whatever its form, regulation needs to be effective. A lack of effective powers is not necessarily consistent with “light handed” regulation.

1.9 This study, therefore, provides a series of propositions that could increase the effectiveness of FICORA. These propositions include additional tools that could be used to regulate in different circumstances. This does not mean that FICORA should use them to regulate in all cases. But for FICORA to be more effective and to be able to give full effect to the new EC Directives, it is important that it has these tools at its disposal.

Structure of the Report

1.10 This report is structured as follows:

- (a) Chapter 2 presents our understanding of the market structure and of other specific national circumstances in Finland.
- (b) Chapter 3 sets out the Commission's concerns regarding economic regulation in Finland and discusses some issues regarding the transposition of the new directives.
- (c) Chapter 4 presents a summary of the review of economic regulation in Denmark, Italy, Ireland, Sweden and the UK.
- (d) Chapter 5 sets out propositions for FICORA in the following areas: regulatory duties and powers; financial reporting obligations; price setting; and resources used to undertake tasks associated with economic regulation.



2 OVERVIEW OF SPECIFIC NATIONAL CIRCUMSTANCES

- 2.1 Finland has a history of light-handed regulation of telecommunications. The entry to the market is easy, as licences are only needed for provision of public mobile telephony services. Most operators consider that this regime has helped to promote a competitive environment and the emergence of new technologies.

Market Structures

Fixed network market structure

- 2.2 The Finnish fixed line market has been historically very segmented into local service providers and, even after significant consolidation of the market in recent years, there are still 48 operators with SMP status. Some 200 operators in total have notified FICORA of their existence, of which about 100 are reckoned to be public providers. There are large differences between the operators in terms of organisational structure, number of subscribers and geographic area. The smallest operator with SMP has just over 1300 fixed line subscriptions, whereas the two largest have around 500,000 to 600,000 subscriptions (Telia-Sonera and Elisa). The median company in terms of annual turnover has about 20,000 subscribers. Nevertheless, all the fixed line operators with SMP serve close to 100 per cent of the lines in their region.
- 2.3 The majority of local operators act independently in their own areas but, through their membership of Finnet, jointly own trunk lines and a mobile network. Thus there are four established national trunk networks for Finland, operated by TeliaSonera, Elisa, the Finnet Group and Song Networks.
- 2.4 Because of the segmented and diverse structure of the fixed network, FICORA will need to make around 500 full SMP decisions as a result of the new regulatory framework. This, together with the differing characteristics of the operators, poses unique challenges to economic regulation.

Mobile network market structure

- 2.5 There are three mobile network operators: TeliaSonera, Elisa and Finnet, each of which has several service providers under different brands. (In addition, there is one local mobile operator, active only on the archipelago of Ahvenanmaa). Mobile penetration is 90 per cent, with 35 per cent of households using only mobile communications.
- 2.6 Number portability on 25 July 2003 led to considerable churn in the market, made easier by the fact that the typical subscriber in Finland has single rate for domestic calls and SMS, regardless of the receiving network.
- 2.7 Fixed to mobile termination is charged as a mobile call fee to the calling fixed line customer. This is a retail charge, and therefore does not come under regulation in Finland. A proposed amendment to the Communications Market Act, currently in Parliament is aimed, in part, at removing this quirk in the present legislation.



FICORA's Powers and Procedures

Legislation

- 2.8 The EC legislative framework was transposed, to the Commission's satisfaction, into national law through the Communications Market Act on 23 May 2003. The provisions of the Act became effective on 25 July 25 2003. Cost-orientation of wholesale prices remains a concern, with price regulation focused on controlling the SMP operators' wholesale prices, such as for interconnection and for the access to the local loop. The law does not provide for regulation or cost-orientation of retail prices of individual products or services, though fixed subscriber connections (according to the Section 59 of the new Act) have to be "reasonable in aggregate" (other retail prices are no longer regulated because Finland has only transposed the minimum requirements of the USO directive). The law provides for use of efficiency adjustment in assessing cost orientation, but does not grant ex-ante regulatory or price setting powers.
- 2.9 FICORA can oblige an operator to use a cost accounting system and to produce separated accounts, but has no power to impose any particular form of cost accounting on any operator (and FICORA is aware of great diversity in the methods chosen). Conversely, when assessing an operator's cost orientation, FICORA is not bound to use the operator's own cost accounting method.

Enforcement and appeals

- 2.10 If its decision is not complied with within one month, the 2003 Act gives FICORA the right to order an operator to act. A conditional fine up to 5 per cent of turnover or a threat of termination of operations can also be levied upon the defaulter. However, FICORA has not yet used its power to impose a fine. The Market Court determines the conditional sanctions on proposal by FICORA, which takes into account the amount of harm done. The threat to terminate operations can be used if an operator seriously and significantly fails to comply with the Act or decisions under it, and does not change conduct within one month despite being requested to do so.
- 2.11 FICORA has the right to request information and carry out technical inspections to ensure compliance. FICORA however can only make an economic inspection in special circumstances.
- 2.12 In general, an appeal can be made against the Ministry's or FICORA's decisions to the Administrative Courts (either regional or Supreme). FICORA also has the right to appeal Administrative Court decisions. Certain of FICORA's decisions – principally, though not only, those on market analysis, resulting obligations and related matters – can only be appealed to the Supreme Administrative Court. Currently, however, decisions from investigations from FICORA's own initiative are first appealed to the regional Administrative Courts. In all decisions, however, FICORA may order that its decision be complied with while the appeal is heard, unless the appellate authority orders otherwise.



Amendment proposal

- 2.13 A proposed amendment to the Communications Market Act 2003 would change the Act in two main ways. First, it would give fixed carriers the right to purchase termination on a wholesale basis from mobile operators when the fixed subscriber uses carrier selection or pre-selection. This would bring fixed-to-mobile termination within regulated charges, and would enable FICORA to impose obligations on a mobile operator with SMP in fixed-to-mobile termination. (FICORA has already exercised this power in mobile-to-mobile and international-to-mobile call termination.)
- 2.14 Secondly, this amendment would give FICORA power to set a wholesale access price ceiling, as well as imposing the current cost orientation obligation. FICORA would also gain the power to set a maximum level of charges on a case-by-case basis as it evaluates the cost orientation of an operator's wholesale prices.

Practice

FICORA'S practices

- 2.15 Under the Communications Market Act 2003 FICORA undertakes ex-post wholesale price assessment (though not, as we have explained, price determination) of operators with SMP. If effects observed in the wholesale market are found not to promote competition in the retail market, certain obligations, such as reasonable pricing, non-discriminatory behaviour, or no product or service bundling, can be imposed.
- 2.16 In general FICORA aims to impose remedies that are proportional not only to the size of the effect on the market but also to the size and operational capacity of the incumbent in question. So far, FICORA has imposed 35 cost orientation and cost accounting system obligations as part of the new SMP decisions. Although the operators are free to choose their own methodologies, FICORA has published guidance and examples concerning the methods it uses in evaluating compliance with the various obligations.
- 2.17 FICORA supervises the cost orientation of charges through investigations on its own initiative and in response to disputes between operators. Ex-post evaluations are based primarily on data provided by the operator in question, typically on historic costs except in relation to network assets. The reasonableness of the rate of return is then assessed using WACC and CAPM, although FICORA has never evaluated reasonable return in an individual case. Cost efficiency can be examined only if there is reason to doubt it.
- 2.18 If the charges are found not to be cost orientated, FICORA can order the company to lower the charges, though it cannot set the price level. In some cases the incumbents have lowered their prices during investigation, and FICORA has thus concluded that the prices are cost orientated and closed the investigation. This has led to complaints by entrants about the lack of transparency of the process and the basis on which the charges were lowered. It is possible that an operator may choose to lower prices by an amount that FICORA does not regard as sufficient to satisfy the requirement of cost orientation. If



that happens, the process has to begin again and can in theory be repeated until FICORA is satisfied.

- 2.19 Evaluations of cost orientation so far indicate that wholesale charges for both fixed and mobile have sometimes included costs that do not belong in network operations, and that the replacement value of the network includes totally depreciated network elements. Returns on capital have also been found to be unreasonable because of errors in the valuation of the capital base and because of differences between required and actual returns. More recent decisions have found that operators have not been able to adequately justify the cost orientation of their charges.
- 2.20 FICORA told us that the balance of its workload seems to be now shifting away from the resolution of disputes initiated by third parties (and thus beyond FICORA's ability to control in relation to workload) and more in favour of investigations initiated by FICORA itself. At the same time, it was still generally embroiled quite deeply in assisting unofficially to resolve prospective disputes between operators before they were formalised. FICORA's powers to act as a mediator where parties in dispute so request had so far been little used. Where such powers were used, it was generally on FICORA's own initiative.

Financial reporting

- 2.21 Accounting separation has been considered to be one of the more intrusive remedies available and therefore has not been imposed very widely. The obligations of accounting separation and cost accounting are used to support and verify cost orientation of charges. FICORA can require the separation of four accounts: fixed interconnection, mobile interconnection, fixed access, and other.
- 2.22 In the past, audits were carried out by FICORA, but the Communications Market Act 2003 transferred the audits to independent auditors, i.e. to the firms that perform statutory audits for the regulated companies themselves. FICORA has published a brief document, giving guidelines for the audit process and setting out its scope. For the cost accounting system the audit targets are the system and procedures used, as well as cost oriented pricing and pricing calculations. The first audit reports under the new regime will be delivered in August or September 2004.
- 2.23 FICORA told us that, so far, it has not made systematic use of separated accounts, mainly because of doubts about their reliability. It acknowledges that it has yet to develop the content of separated accounts whereby it can routinely use separated accounts to shed light on the possible presence of anti-competitive activity.

The courts

- 2.24 FICORA's decisions can be appealed to judiciary system as described in paragraph 2.12 above. In the past the appeal process has been lengthy, but the 2003 Act could speed it up. The Act also allows for FICORA to order that its decision must be complied with despite any appeal unless the appellate authority orders otherwise. The Supreme



Administrative Court has recently given rulings on four such appeals, suspending FICORA's decision in three of the four cases, pending the conclusion of the appeal process.

- 2.25 It is not intended under previous legislation or under the new legislation that decisions rendered by the Supreme Court should be retrospective in effect. (In other words, even if the Court upheld a decision of FICORA, the decision itself could be applied only from the date of the Court's ruling.)
- 2.26 There is no *de minimis* provision applying to cases heard by the Supreme Administrative Court, and the Court itself has the power to try matters of substance, not just of process (in which respect it differs from a number of courts in other jurisdictions, where only process can be tested.)
- 2.27 However, an aggrieved third party can sue for compensation through the civil courts.

Collaboration with FCA

- 2.28 Both FICORA and the Finnish Competition Authority (FCA) are responsible for creating and maintaining viable competition in the communications market. The FCA has actively applied competition law to telecommunications operators on issues such as discriminatory pricing and price squeezes, also hoping that the threat of action will prompt other operators to review their charging structures voluntarily.
- 2.29 FICORA and the FCA have published a memorandum of understanding and cooperation between them. They hope to avoid inconsistent decisions and overlapping regulatory actions in the same case. FICORA and FCA consider that obligations based on sector-specific regulation will be eased and eliminated when market developments give reasons to do so. FICORA reported that the FCA is satisfied with FICORA's present regulatory powers and the division of powers between FICORA and the FCA, but has recently resisted the proposed application of price ceilings.



3 CONCLUSIONS FROM THE EC REGARDING TRANSPOSITION

General Observations Regarding the New Regulatory Framework

- 3.1 The new European regulatory framework for electronic communications was adopted in 2002, to be applied as of July 2003.
- 3.2 In the 2003 report on the implementation of the EU Electronic Communications Regulatory Package, the Commission notices that much has been accomplished by Member States to transpose the new regulatory framework into national law. The report presents the Commission's assessment of the transposition of the new framework as at 1 November 2003 and it does not contain country-specific information.
- 3.3 Nevertheless, the Commission highlights some general concerns as regards to a number of issues across different Member States, considered of particular importance:
- (a) **The wider powers and discretion conferred on NRAs.** The Commission notes that some Member States limit the NRA's ability to exercise the full range of powers contemplated by the new framework, e.g. the power to impose publication of a reference offer, or transparency of internal transfer pricing, the power to intervene on its own initiative, and to order changes to a reference offer.
 - (b) **The assignment of tasks attributed to NRAs.** Each Member State can assign the tasks attributed to an NRA to different competent bodies, provided that the division of tasks is clear and it is published in an easily accessible form. The Commission observes that in some Member States the powers accorded to an NRA are so dispersed that their effective exercise and coordination may be in doubt.
 - (c) **The availability to NRAs of the full range of remedies provided for in the new framework with the flexibility to tailor them to specific circumstances.** The Commission points out that in some countries primary legislation predetermines the nature of the remedies to be imposed as a result of a finding of SMP in a particular market, thus potentially limiting the NRA's discretion to determine the most appropriate remedy in a specific case.
 - (d) **The timely completion of the market analysis and review of existing obligations by NRAs.** The Commission observes that NRAs should complete the market analysis as soon as possible after the introduction of the new framework. However, some Member States do not set any time limit or set a very extended time limit for carrying out the first reviews.
 - (e) **The appeal process.** The Framework Directive requires that decisions by NRAs should be subject to appeal and decisions should stand unless the appeal body decides otherwise.



Implementation in Finland

- 3.4 The Commission has often pointed out that Finland has a “light regulatory regime” as compared with other Member States, and that the Finnish authorities have traditionally relied more upon market forces than detailed regulation.¹
- 3.5 It also recognises that the large number of operators with significant market power (SMP) in Finland represents a “particular challenge in terms of workload to the FICORA”² and in terms of potential effectiveness of regulation:
- “In Finland the extremely high number of SMP undertakings creates difficulties for the NRA in ensuring compliance with their obligations, potentially leaving new entrants without the necessary regulatory guarantees.” (COM(2002) 695, p.19)
- “Concerns expressed by the new entrants in the past regarding the hands-off approach of the authorities and the absence of ex-ante detailed regulation and efficient implementation of existing rules remain, even though they welcome the efforts made by the NRA in the last year to verify the cost accounting systems of eighteen SMP operators” (COM(2002) 695, p.157)
- 3.6 The new regulatory framework strengthens the remedies at NRAs’ disposal and the potential effectiveness of their implementation. Effective implementation of regulation requires these powers to be used to their full extent and Member States must ensure that NRAs are equipped with appropriate powers to carry out a variety of tasks including analysis of relevant markets, identification of SMP operators, dispute resolution, the imposition of regulatory and universal service obligations and the enforcement of authorisation conditions.
- 3.7 The Commission highlights that heavy national procedures and lack of resources on the part of NRAs are identified by the market as a brake on effective regulation and in some cases, as for example in Finland, it reports the suggestion by entrants that organisational improvements may enable regulators to address issues in a timely and efficient manner.³
- 3.8 Following the first market reviews within the new framework, FICORA found the markets for international and long-distance voice telephony to be sufficiently competitive and therefore no requirements of cost-orientation are imposed on SMP operators in these markets. In 2002 Finland was the only country to remove the obligation of cost orientation for national and international calls.
- 3.9 The Commission used its veto power on a decision by FICORA that there are no operators with SMP in the market for international calls provided at a fixed location. The Commission found that FICORA’s draft measures would not give rise to sufficient

¹ COM(2002) 695, p.157

² COM(2002) 695, p.157

³ COM(2002) 695, p.5 and p.18.



evidence or analysis to support a conclusion that the market for international calls is effectively competitive, and required FICORA to withdraw them. The matter has not yet been concluded.

Implementation of Previous Directives

Interconnection and access charges

- 3.10 In the 2002 Report, the Commission remarks that problems with the completeness of the Reference Interconnection Offers (RIO) had been resolved in all Member States. However, it highlights that problems with the tariff offer for interconnection at local level had still been reported in Finland,⁴ where the charges levied by SMP operators for terminating calls on their fixed networks were reported to be among the most expensive in the EU for all levels.⁵
- 3.11 The Commission reports complaints by new entrants in the Finnish telecommunications market that tariffs are not set at a level that is able to allow sustainable competition and that there is a lack of accountability on the part of incumbent operators, with new entrants subject to charges without any evidence of cost orientation being provided to justify their level.⁶
- 3.12 These complaints – the Commission observes – may not be unfounded given the results of the investigations of interconnection charges of some of the biggest SMP operators carried out by FICORA, which found out that in many cases tariffs were not cost-oriented and that the operators' cost accounts were not in compliance with the telecommunications legislation.
- 3.13 However, investigations have been protracted and in several cases incumbent operators have appealed FICORA's decisions. The Commission laments the length of appeal procedures in the past – a problem that is being addressed by the new Communications Market Act.
- 3.14 Moreover, although the investigations have led to a reduction of charges, new entrants point out that they have contributed very little to the transparency of interconnection charges.⁷ The Commission also suggests that these findings:

[...] cast more light on the new entrants' long-standing demand that the NRA act resolutely and swiftly to prevent and remedy the problems identified, and monitor compliance with its decision" (COM(2002), p.157)

⁴ COM(2002) 695, p. 21.

⁵ COM(2002) 695, p.158.

⁶ COM(2002) 695, p. 157 and p.160.

⁷ COM(2002) 695, p.159.



Cost accounting and accounting separation

- 3.15 Under the 1998 regulatory framework, NRAs were responsible for ensuring that the cost accounting systems of notified operators were suitable for applying the tariff principles set in the directives, in particular relating to transparency and cost orientation.
- 3.16 A key element of compliance with the principles in EU law regarding costing was therefore the existence of a verification process of the operators' accounts.
- 3.17 In almost all Member States, an independent third party audits the accounts of incumbent operators, although in many cases the NRAs carry out additional verification procedures. In Finland, however, as in Austria and Germany, the regulator performed all verification procedures itself. In Finland now, the Communications Market Act 2003 transferred the audits to independent auditors.
- 3.18 The Commission observes that across Member States there is still considerable work to be done with regard to the verification and certification of accounts by NRAs, in order to ensure compliance by incumbents with transparency and cost orientation, and that Member States are in fact working on improving the cost accounting models and cost orientation of charges and tariffs.
- 3.19 The Commission regards the implementation of cost accounting and accounting separation in Ireland and in the United Kingdom as best practice in the EU with respect to the approach and methodology used, the detail of the verification carried out by the regulators and the availability of information to third parties.
- 3.20 With regard to Finland, the Commission acknowledges the large number of operators with SMP, and the fact that each of them is developing its own model. However, it launched an infringement proceeding against Finland in 2001 because up to 2001, no systematic independent verification of compliance with the cost accounting system of SMP operators had been conducted by FICORA and no annual certificate concerning compliance had been published.
- 3.21 In the second half of 2001 and in 2002 FICORA investigated the 2000 cost accounts of 18 SMP operators. The investigations were carried out at a general level and FICORA concluded that any verifiable link between the cost accounting systems and the pricing systems applied was weak and that the cost accounting systems were generally not adequate in terms of the aims of the Telecommunications Market Act.
- 3.22 However, no public information was made available concerning the outcome of the verifications as concerns each individual company audited. Moreover the Commission



reports that, although the scope of audits undertaken by NRAs is usually comprehensive, Finland performed only a high-level review of some parts of the models.⁸

- 3.23 FICORA indicated that the findings of the audits were discussed with all companies concerned and that it trusts that these companies will proceed with the necessary modification of their cost accounting systems. However, the Commission expressed some concern regarding:

“whether and how FICORA will ascertain this and which remedies or sanctions it will impose on companies that may continue to breach their regulatory obligations”.
(COM(2002) 695, p.167)

- 3.24 The Commission suggested that one possible approach would be for FICORA to establish the minimum standard that the cost accounting systems of all SMP operators would have to comply with. However – the Commission reported – FICORA does not consider this to be possible, due to the lack of powers to regulate cost accounting systems; operators are free to choose all aspects of their methodology. The Commission has expressed concern about this lack of power to stipulate a particular cost accounting system on any operator on several occasions.⁹ Also, substantial differences in size and other characteristics of the SMP operators pose challenges. FICORA is instead drawing up general non-binding guidelines to assist the operators to develop their cost accounting systems.

⁸ COM (2002) 695, p.37.

⁹ SG (2003) D/233786 p.3, for example.



4 FINDINGS FROM COMPARATIVE STUDY

- 4.1 This section provides a summary of the main findings of our review of economic regulation in Denmark, Italy, Ireland, Sweden, and the UK in each of the following areas:
- (a) Regulatory powers
 - (b) Financial reporting obligations
 - (c) Price setting; and
 - (d) Resources.
- 4.2 On behalf of FICORA, Europe Economics would like to thank the regulatory authorities in the five Member States who participated in the study for their co-operation, time, and assistance.¹⁰

Regulatory Duties and Powers

- 4.3 This section reviews regulatory powers in the following areas:
- (a) appeals;
 - (b) dispute resolution; and
 - (c) sanctions.

Appeals

- 4.4 Article 4 of the Framework Directive concerns the issue of appeals against an NRA's decision:

“1. Member States shall ensure that effective mechanisms exist at national level under which any user or undertaking providing electronic communications networks and/or services who is affected by a decision of a national regulatory authority has the right of appeal against the decision to an appeal body that is independent of the parties involved. This body, which may be a court, shall have the appropriate expertise available to it to enable it to carry out its functions. Member States shall ensure that the merits of the case are duly taken into account and that there is an effective appeal mechanism. Pending the outcome of any such appeal, the decision of the national regulatory authority shall stand, unless the appeal body decides otherwise.

2. Where the appeal body referred to in paragraph 1 is not judicial in character, written reasons for its decision shall always be given. Furthermore, in such a case, its decision

¹⁰ The discussion of ComReg below is limited, as ComReg did not want some of the information discussed at interview to enter the public domain (although they were happy for it to be made available to FICORA).



shall be subject to review by a court or tribunal within the meaning of Article 234 of the Treaty.”

- 4.5 Appeals have been traditionally brought before general administrative courts, whose judicial reviews are normally limited to process rather than substance, and generally produce lengthy appeals. However, some countries (such as Denmark and Ireland) have introduced or are introducing expert appellate bodies.
- 4.6 In Denmark the Complaints Board is the final administrative mechanism to hear complaints. IT-og Telestyrelsen believes that the Complaints Board is a useful mechanism and interested parties usually seem to have confidence in its decisions.
- 4.7 In Ireland ComReg’s decisions can be appealed in front of an Appeal Panel. Grounds of appeal may include errors of fact and or errors of law, including issues of jurisdiction and procedure.
- 4.8 An important feature of the appeal system, which is likely to impact on the efficacy of regulation, is the status of the NRA’s decisions during appeals. In general, NRA’s decisions stand during appeal unless the appellate authority explicitly suspends the decision.
- 4.9 The Member States that we reviewed differed in the extent to which NRA’s decisions are suspended during appeal procedures. In Sweden, for example, PTS’s decisions can be – and in some cases have been – suspended during appeals on the incumbent operator’s request. PTS believe that this affects the efficiency of the regulatory system as it leads to delays and introduces uncertainty in the market. In Italy, on the other hand, the Courts have never granted a suspension despite Telecom Italia appealing against many of Agcom’s decisions.

Dispute resolution

- 4.10 Article 21 of the Framework Directive concerns the resolution of disputes between undertakings:

“1. In the event of a dispute arising in connection with obligations arising under this Directive or the Specific Directives between undertakings providing electronic communications networks or services in a Member State, the national regulatory authority concerned shall, at the request of either party, and without prejudice to the provisions of paragraph 2, issue a binding decision to resolve the dispute in the shortest possible time frame and in any case within four months except in exceptional circumstances. The Member State concerned shall require that all parties cooperate fully with the national regulatory authority.

2. Member States may make provision for national regulatory authorities to decline to resolve a dispute through a binding decision where other mechanisms, including mediation, exist and would better contribute to resolution of the dispute in a timely manner in accordance with the provisions of Article 8. The national regulatory authority shall inform the parties without delay. If after four months the dispute is not resolved, and if the



dispute has not been brought before the courts by the party seeking redress, the national regulatory authority shall issue, at the request of either party, a binding decision to resolve the dispute in the shortest possible time frame and in any case within four months.

3. In resolving a dispute, the national regulatory authority shall take decisions aimed at achieving the objectives set out in Article 8. Any obligations imposed on an undertaking by the national regulatory authority in resolving a dispute shall respect the provisions of this Directive or the Specific Directives.

4. The decision of the national regulatory authority shall be made available to the public, having regard to the requirements of business confidentiality. The parties concerned shall be given a full statement of the reasons on which it is based.

5. The procedure referred to in paragraphs 1, 3 and 4 shall not preclude either party from bringing an action before the courts.”

- 4.11 In Sweden, the NRA suggests that dispute resolution does not necessarily contribute to its effectiveness as a regulator. This is largely because there are many disputes and this can mean that PTS is reactive rather than proactive. PTS believe that they could be more effective if they could move away from dispute resolution on issues where they have made judgements through their supervision role. This may be better for smaller operators who might not have the resources to come to PTS with a formal complaint.
- 4.12 Under the 2003 Communications Code, Agcom has the power to issue a binding Decision on a dispute between operators following a request of one of the parties, within 4 months and unless the parties had agreed on a different mechanism for dispute resolution. In 2002, Agcom dealt with 11 disputes between telecommunication operators regarding fixed lines. In 2003 Agcom dealt with 26 disputes between operators.
- 4.13 Formal disputes are relatively few in Ireland. Inter-operator issues are often dealt with as part of ComReg’s ongoing work programme.
- 4.14 In the UK, whenever a dispute is referred to Ofcom, it has the right to reject it if it considers that alternative means of achieving a prompt and satisfactory resolution are available. If they accept a dispute it will normally have to be resolved within four months. This period, however, may be extended in exceptional circumstances, or where the dispute also relates to matters within the jurisdiction of the regulatory authorities of another Member State.
- 4.15 In making a determination resolving a dispute, Ofcom may do one or more of the following:
- (a) make a declaration setting out the rights and obligations of the parties to the dispute;
 - (b) give a direction fixing the terms or conditions of transactions between the parties to the dispute;



- (c) give a direction imposing an obligation, enforceable by the parties to the dispute, to enter into a transaction between themselves on the terms and conditions fixed by Ofcom; and
 - (d) give a direction, enforceable by the party to whom the sums are to be paid, requiring the payment of sums by way of adjustment of an underpayment or overpayment.
- 4.16 A dispute determination by Ofcom is binding on all parties involved. All decisions of Ofcom in respect of the regulation of electronic communications networks and services are subject to a full appeal on the merits to the Competition Appeals Tribunal. Such appeals cover anything from errors of fact and law to Ofcom's discretion. Appeals relating to price control are however referred by the Tribunal to the Competition Commission, whose determination is binding on the Tribunal.

Sanctions

- 4.17 Sanctions can in theory be imposed directly by the NRA or by a different judicial or non-judicial body.
- 4.18 It is important that the power to impose sanctions is credible. In particularly serious cases of non-compliance, NRAs are usually endowed with powers to suspend the right to provide service in urgent cases and in the case of serious and repeated contraventions where financial penalties or enforcement notifications have failed to secure compliance.
- 4.19 Some NRAs we interviewed felt that an operator may expect the NRA not to be able to use the power to impose a particularly large fine because of the political costs associated with such a sanction. In Denmark, IT-og Telestyrelsen did impose sanctions on operators for a variety of issues (such as not providing data when requested).
- 4.20 Several NRAs have suggested that operators do not want the bad publicity associated with not cooperating or complying with the NRA (e.g. Sweden). The operator would be very sensitive to its public image and the effect that a fine could have on it as a listed company.
- 4.21 For these reasons, the publicity of non-complying behaviour and of the imposition of sanctions can be considered an important deterrent mechanism.

Financial Reporting Obligations

- 4.22 Cost accounting systems (CAS) and accounting separation are two separate, but closely related financial reporting obligations often imposed on operators with SMP as a response to particular regulatory issues. Cost accounting systems can take significant resources to develop and can be very detailed. This level of detail is, in many cases, necessary to demonstrate cost orientation, but it usually comes at the expense of transparency. One of the main benefits of a CAS is that it can demonstrate cost orientation.



4.23 Separated accounts, in contrast, are relatively easy to prepare once detailed cost accounting systems are in place. They can be seen as a way of presenting the results of a CAS and can be used to demonstrate non-discrimination (if they show transfer charges). The experience of the five Member States with CAS and with separated accounts is discussed separately below.

Review of cost accounting systems

4.24 Cost accounting systems (CAS) are produced in the five Member States reviewed in this study. These are considered to be crucial in showing that proposed charges are cost oriented, but are often difficult to verify.

4.25 Some of the regulatory authorities have a process for reviewing the outputs of the cost accounting systems of incumbents. For example, IT-og Telestyrelsen undertake the following process:

- (a) Accounts received.
- (b) Review auditors' statement.
- (c) Conduct an initial review to see if anything unusual is taking place.
- (d) Send to Competition Authority.
- (e) Compare with past statements to identify any changes.

4.26 It is quite common for IT-og Telestyrelsen to ask for more information if there is any doubt. Typically, they review the documentation sent by TDC to explain certain costs and this often ends with a requirement on TDC to develop certain allocation keys (for example).

4.27 Because of the size and complexity of these models, many regulatory authorities do not expect to develop a detailed understanding of all aspects of the CAS. Instead, they try to get to the stage where they can have confidence in some of the numbers. Some of the ways by which regulatory authorities try to gain such confidence include:

- (a) Look at the audit opinion (discussed in more detail below);
- (b) Look at changes from one year to another.
- (c) Ask for further information (documentation of cost drivers and explanation of allocation keys) for any specific areas of concern.

4.28 In Sweden, it usually takes around six months from when Telia submit their proposed charges with their model to when a final decision is made. The fixed model is a quite detailed top-down model while the mobile model is much more simple. The process usually involves a series of questions from PTS to Telia and several meetings. If at the end of this process a decision cannot be reached, then a formal Decision will need to be made.



- 4.29 Other countries have taken a slightly different approach. The UK, for example, has decided to establish the rules as clearly as they can and then require BT to report its costs according to those rules. Over the past few years, the nature of the CAS has changed as Ofcom required changes to meet its regulatory objectives. In most cases these changes were discussed and negotiated with BT, although in a couple of instances, more formal determinations were needed. The approach in the UK is, therefore, one of on-going review, rather than a formal annual review.
- 4.30 Agcom has released specific criteria and guidelines on cost accounting systems, as well as accounting separation, which are checked by the auditor during its review.

Separated accounts

- 4.31 The regulatory authorities we interviewed do review separated accounts although they did not always consider these to be as useful as the main CAS.
- 4.32 In Denmark, in connection with IT -og Telestyrelsen's supervision of business segment accounts, the National Telecom Agency requests an opinion from the Competition Council as to whether there has been a violation of the rules on cross-subsidisation. The opinion of the Competition Council is binding for the National Telecom Agency's decision in pursuance of its obligation to carry out accounting supervision.
- 4.33 Information from the separated accounts is not used systematically to resolve disputes or to check for non-discrimination in Sweden. PTS may investigate further if a comparison of the separated accounts shows unusual year-on year changes.
- 4.34 In Ireland, separated accounts are used extensively in support of cost orientation and other regulatory tasks.
- 4.35 Ofcom argued that separated accounts were very closely linked to the CAS and indeed needed to be in order to provide confidence in the numbers. An effective accounting separation regime, according to Ofcom, needed to contain profit and loss information and other details in order to allow transfer prices and other relevant data to be verified.
- 4.36 Regulatory authorities, therefore, typically used separated accounts — along with additional information that is not always made publicly available — as an additional way of verifying cost orientation.

Auditors

- 4.37 The five NRAs interviewed did review audits of separated accounts and cost accounting systems.
- 4.38 The audit opinion prepared by the company's own external auditors is considered to provide important information for IT -og Telestyrelsen's own reviewing process. However, for the first set of accounts produced by TDC and Sonofon in 1998 IT -og Telestyrelsen -



with the assistance of CPA's - decided to have a second audit with a particular focus on verifying the opening balances.

- 4.39 PTS rely on Telia's auditors to review input data to the model. PTS review the model in itself and the results. PTS always has the possibility to engage their own auditor.
- 4.40 ComReg stated that the accounts are independently audited by PricewaterhouseCoopers who have been appointed by eircom. As part of its review of interconnection rates and other products ComReg also performs its own review of certain elements of the accounts.
- 4.41 In the UK, Ofcom sees an independent audit opinion as an important element of the compliance process giving a degree of assurance on BT's costs. Additionally, however, another key and complimentary validation process is their ongoing review of the accounting documents (in their broad sense) and their discussion with BT on issues as they arise.
- 4.42 They are soon to gain the option of requesting the provision of an audit opinion on supporting financial information (additional to the primary statements) although this is only likely to be used in exceptional circumstances on a limited set of financial data. Ofcom believe that it is important to "know what you get and what you do not get from the audits". They are comforted by the fact that they have conducted a number of investigations over time and have gained some insights on what is behind some of the numbers. However, they believe it is unrealistic to undertake a financial audit (using the statutory audit model) themselves, as it requires a set of skills and expertise that only auditing firms can realistically provide.
- 4.43 In Italy an independent third party, appointed by the Authority, audits cost and regulatory accounts and account separation every year and Agcom's intervention is limited to broadly overseeing the auditor's activity. Agcom subsequently publishes certified accounts.

Price Setting

- 4.44 The NRAs reviewed in this study set prices for interconnection products in different ways. On the one hand, there are NRAs such as IT-og Telestyrelsen who play a more direct role in setting prices for interconnection. IT -og Telestyrelsen recognised that there was an information asymmetry in relying on the incumbent operator to produce proposed interconnection charges and now estimate interconnection charges through their own "hybrid LRAIC" model.¹¹ This model was developed after a reconciliation between a top-down model produced by TDC and a bottom-up model developed by other operators in Denmark. PTS in Sweden recognised a similar information asymmetry, and has

¹¹ A hybrid model is a cost model developed as a result of reconciling the results of a bottom-up model with a top-down model. By taking the best features — and most reliable and appropriate information — from each model, it is considered a "hybrid" of the two approaches.



- developed a long run incremental cost (LRAIC) model, which it is also hoping to use to set cost oriented interconnection charges in the future.
- 4.45 One of the advantages of such an approach is that it provides greater transparency to the regulatory authority regarding the source and make-up of interconnection charges. Although such models can be resource intensive to develop and reconcile, they may minimise the need to systematically review the cost accounting systems of incumbent operators.
- 4.46 On the other hand, there are NRAs such as Ofcom and Agcom that rely on the incumbent operator — at least as a starting point — to provide interconnection charges. In Italy, charges are determined on the basis of top-down “models” based on Telecom Italia’s regulatory accounts. The Authority has not developed its own internal cost models to set charges but the level and detail of Agcom’s assessment of Telecom Italia’s cost models has increased over time. In 1998-2000, the Authority essentially assessed Telecom Italia’s interconnection prices on the basis of reference to international best practice. Since then Agcom has relied more on its own internal analysis of Telecom Italia’s cost models to assess Telecom Italia’s RIO, although this is not made transparent to other operators. Since 2003, Agcom has introduced a system of price controls that covers most of the services in the RIO.
- 4.47 Agcom observes that the technical issues, which are particularly difficult to regulate and monitor, can be as important as economic aspects to allow effective competition to develop.
- 4.48 Interestingly, in the matter of price setting, the powers of Agcom have changed with the introduction of the 2003 Communications Code that implements the new regulatory framework. Under the previous legislation, the Authority could directly modify the RIO – on both economic and technical aspects – and impose regulated prices, and it did so in some occasions. Under the new Code, however, the Authority can only ask the notified operator to fully justify its prices and to modify them (in line with Agcom’s indications) if necessary but it cannot impose prices directly.
- 4.49 The separated accounts provide visibility on most interconnection charges in the UK. However, these accounts cannot currently be used to demonstrate that ULL charges are cost oriented. BT is currently discussing a set of outputs that will be able to show this in the future; at the moment Ofcom relies on other information to review whether BT’s proposed charges are cost oriented.
- 4.50 One of the main issues for PTS to deal with when reviewing Telia’s proposed charges is the time lag between Telia’s costs (as shown in the FDC model) and the proposed interconnection charges, which need to apply at some point in the near future. The types of debates that PTS tends to become involved in are those to do with volume forecasts that underlie the proposed interconnection charges. Increasing IP traffic migration and ADSL also make it difficult to allocate costs to different services.



- 4.51 Other fixed operators with SMP under the new framework in Sweden are required to offer termination at a charge that is considered “fair and reasonable”. Normally fair and reasonable prices should be on the same level as cost oriented charges. PTS have given strong hints that they interpret this as meaning that charges will be reciprocal.
- 4.52 ComReg believes that there are many practical advantages associated with the use of price controls and is will consider their use in appropriate markets as part of its market review. Currently, interconnection rates are using eircom’s top-down accounting. In 2002 these were compared to costs derived from a bottom-up model. ComReg has determined that the cost of the local access network should be derived using LRIC principles. ComReg and industry have developed a bottom up model to implement LRIC although no consensus has been reached regarding the appropriateness of certain inputs to the model. ComReg has recently consulted on the possibility of using operating costs that have been estimated using an econometric model that draws on data from US LECs as an input and also on certain network design parameters.
- 4.53 Efficiency adjustments also feature in the Danish hybrid LRAIC model. In that model, any operating costs that came from TDC were subject to a 10 per cent efficiency adjustment.

Resources

- 4.54 IT-og Telestyrelsen’s Market Division has a staff of about 20 working on (wholesale) regulation (including economic regulation). The issues being dealt with include interconnection, financial reporting obligations, market analysis and dispute resolution. The mix of the staff working on these will depend on the particular issues facing IT - og Telestyrelsen at any one time. For example, during the LRAIC model-building phase, a number of people were working on interconnection-related tasks. The staff are from different disciplines, but can work across issues. They are mainly made up of economists, lawyers, and business lawyers.
- 4.55 There are people in other sections that also deal with economic regulation. For example, in the consumer affairs division the staff look at issues such as the maximum price for leased lines. Other task undertaken by consumer affairs include price comparison (to help consumers make their choice) and dealing with complaints.
- 4.56 IT-og Telestyrelsen do outsource some tasks, but this is on an irregular basis. They have outsourced assistance on LRAIC modelling which was a large task and do look for external help for smaller, technical audits on specific issues. IT -og Telestyrelsen also contracted with consultants to assist them in reviewing the separated accounts in 1998. They also have an (external) Government legal service that they can refer to and use this as back up on legal issues. This external legal advisor is a lawyer appointed by royal resolution who advises and represents all state authorities and firms in e.g. court cases.
- 4.57 In terms of total numbers, the PTS resources involved in economic regulation are largely found in the Market Affairs Department. This Department undertakes the following functions:



- (a) Competition affairs supervision, which has 13 staff and is involved in the supervision competition issues such as the fixed and mobile LRAIC models as well as ensuring representation on ERG Committees. Dispute resolution probably requires around two full time staff effort. Technical and pricing issues for ULL and monitoring compliance with the licence conditions on the 3G operators take up about 2-3 staff. Dealing with appeals also uses up around one to two full time staff.
 - (b) Dispute resolution is based on the legal department with assistance from the market affairs department. About 2 full time staff are used from the market affair department per year. About 5 staff from the legal department works with dispute resolution.
 - (c) Consumer issues, which has about 7 staff is involved in consumer protection and consumer complaints.
 - (d) Market obligations, which currently has three staff and likely to grow to five, is involved in USO and SMP decisions, including market definitions, designation of SMP-operators and related obligations and also assistance to the legal department in case of appeals of SMP decisions.
 - (e) Market analysis, which has around five staff, and is involved in analysing the telecommunications market in Sweden. They also co-operate with the Market Obligations people.
- 4.58 The Competition Affairs Supervision within the Market Affairs Department does much of the competition supervision in PTS. It is difficult to provide any firm guidance on the activities that the staff in the Competition Affairs Supervision because the past two years have been special years with quite a lot of effort focussed on developing LRAIC models and on the SMP work.
- 4.59 PTS occasionally use external audits/reviews when considering pricing proposals from Telia, particularly on the fixed side. On the mobile side, the issues have so far been have so far been slightly more theoretical and PTS have engaged a Professor from the School of Economics for the past year and a half to support them with their Decisions.
- 4.60 Agcom were not able to discuss staff numbers as they are currently redefining the allocation of specific human resources to various activities. They did state that outsourcing has been used when the law required the intervention of an independent third party, e.g. the auditing of regulatory accounts. The Authority has rarely outsourced other activities. Currently, an external consultant is advising the Authority in undertaking the market definitions required under the new regulatory framework. In the past, Agcom has sought external advice on developing the guidelines on current costs and has used external researchers, often academic, to produce some general research papers.
- 4.61 Ofcom was not able to comment on resources at this stage, because of Ofcom's relatively short life as a communications regulator. However, although the quantum of resources will depend heavily on the NRA's plans and objectives, it is important that appropriately skilled finance staff are deployed on this work.



- 4.62 The staff involved in economic regulation at ComReg come from a variety of backgrounds, economic, financial and technical. External expertise and advice is obtained as appropriate. Recruiting and retaining appropriately skilled staff is regarded as a key challenge.



5 PROPOSITIONS FOR FICORA

- 5.1 This section draws out the propositions for FICORA from this review. These propositions follow the structure of the discussion in the previous chapter, which set out the findings from the comparative review of economic regulation in the five Member States reviewed.
- 5.2 These propositions make no comment about the need for specific remedies (the need for cost accounting systems or the costing methodology required for different services) or even on the extent of regulation (light handed or more prescriptive). These are policy decisions and will also depend on the findings of the detailed market studies.
- 5.3 However, we have drawn on the requirements in the Directives and on the experience of regulatory authorities in the five Member States reviewed as part of this study and have put together a 'menu' of propositions which could help increase the effectiveness of FICORA once these policy decisions have been made and once the appropriate remedies have been identified as part of the market reviews.

Regulatory Duties and Powers

Appeals

- 5.4 All operators are able to appeal against decisions by NRAs, and incumbent operators in particular are likely to exercise this option. This could hamper the effectiveness of any decisions taken by regulatory authorities. The nature of the appeal process is therefore an important feature of the institutional environment. Lengthy appeal procedures, especially if coupled with the suspension of the NRA's decision, can be an important source of uncertainty in the market and can cause delays to the development of effective competition.
- 5.5 In order to minimise inefficient appeal procedures, it is important that institutions and procedures are designed in a way that promotes the swift resolution of appeals where possible. **We would, therefore, recommend that a specialised Appeal Board or Panel that is able to hear appeals from the parties and make decisions within a reasonable time be created in Finland.** A model for this could be the Telecommunications Complaints Board in Denmark.
- 5.6 Part 27 of the Act on Competitive Conditions and Consumer Interests in the Telecommunications Market (Consolidated Act) in Denmark (Consolidated Act No 661 of 10 July 2003) sets out the structure and scope of the Telecommunications Complaints Board. It states that:

The Telecommunications Complaints Board shall consist of seven members, to be appointed by the Minister of Science, Technology and Innovation. In appointing Board Members, the Minister of Science, Technology and Innovation will consider it important that the overall Board should represent expertise in legal, financial and market-related fields as well as competition law and telecommunications technology.



- 5.7 Section 101 of that Act in Denmark also sets out the nature of complaints that could be submitted to the Complaints Board.
- 5.8 It is also important that, despite appeal, the NRA's decision can hold. These will help to minimize the potential incentive to appeal decisions as a matter of course to profit from the delay in their coming into effect. The decision to uphold or suspend a regulatory decision, however, usually lies with the appellate body and may not be within FICORA's or the relevant Ministry's control. **It should, however, be the norm that that FICORA's decisions be upheld except where the appellate body feels there are strong grounds for setting it aside.**
- 5.9 It is worth noting that in most of the countries studied, the NRAs' decisions have generally been upheld during appeal. This contrast with the current situation in Finland where the Supreme Administrative Court recently held back three out of four of FICORA's decisions, pending the conclusion of the appeal process.

Dispute resolution and NRA initiative

- 5.10 Dispute resolution is increasingly a routine function of regulatory authorities. As stated in chapter 2, FICORA believes that the balance of its workload seems to be shifting away from the resolution of disputes initiated by third parties (and thus beyond FICORA's ability to control in relation to workload) and more in favour of investigations initiated by FICORA itself.
- 5.11 It would be useful for FICORA to develop a set of procedures that could help it become an effective mediator of disputes brought to it by other parties. In these matters, FICORA should consider adopting a set of rules for the outcome of mediation/dispute resolution that draw on Ofcom's approach. For example, FICORA could establish that dispute determination is binding for all parties involved, although an appeal could be made to a specialist body. Disputes brought to FICORA could be resolved within an agreed time period (say, four months), but could take longer in exceptional circumstances. This time limit would need to be lengthened for investigations initiated by FICORA (as opposed to cases simply brought to FICORA) and FICORA-initiated cases will need additional time to collect the relevant data.¹²
- 5.12 Parties, particularly the operator with SMP, would need an incentive to submit to dispute resolution or mediation. FICORA could suggest that if it chose to investigate instead, then it would use its (proposed) new powers to set a maximum level of charges if it found that charges were not compliant with the EU Directives, as transposed in Finland.

¹² In the case of disputes brought to FICORA, the parties come to the NRA with ready-made cases, whereas in NRA initiated investigations the process has to start from the very early stages of data collection in the companies, which will necessarily take time.



Sanctions

- 5.13 Effective regulation requires that the NRA be endowed with – and be willing to use – credible powers to impose significant sanctions on non-complying operators. The credibility of the threat can be affected by the legislated burden and level of proof required from the NRA. NRA's must also be clear about how each sanction will be used.
- 5.14 The incentives of an operator to comply with NRA's decisions depend significantly on the costs that the operator would expect to bear in case of non-compliance, and on other collateral effects associated with a sanction being imposed for non-compliance, most notably those associated with the ensuing bad publicity.
- 5.15 Ensuring that non-compliance is made known to the public may significantly increase the effectiveness of the enforcement mechanism. **We would recommend that any failure to provide relevant information to FICORA or any undue delays in responding to reasonable requests be publicised where possible and subjected to sanctions designed to deter such behaviour.**

Financial Reporting Obligations

Reviewing Cost Accounting Systems

- 5.16 The review of the experience in the five Member States showed that there were three broad models for reviewing the CAS and setting interconnection charges.
- (a) An annual review of the CAS to verify the charges produced by the incumbents.
 - (b) Establishing clear and detailed rules and reviewing these on an on-going basis.
 - (c) Relying on models developed by the regulatory authority to set charges, thus avoiding reliance on the incumbent.
- 5.17 The appropriateness of each of these for Finland is considered below.
- 5.18 First, an annual review of the CAS to verify the charges produced by the incumbents would be time consuming and inevitably high level given the complexity of the models and the resource available (even if more resources were made available to FICORA for this task). Further, it is not clear how effective these reviews actually are, and Denmark and Sweden, for example, are looking to reduce their reliance on charges produced by the incumbent's CAS by developing their own models (see below).
- 5.19 Second, developing and agreeing detailed and specific rules is not straightforward. Ofcom stated that it requires a constructive and professional relationship to be developed between the regulator and the operator. This means that there needs to be experience and understanding of what the regulatory goals are and the regulator also needs to appreciate what can be done and be clear about what specifically is needed. In Finland, the level of expertise of many of the operators may make it difficult to develop such a



relationship. Further, the detailed information that might be needed by each operator may differ, making it difficult to produce a set of guidelines that can meet all of FICORA's regulatory objectives.

- 5.20 Third, developing a single bottom-up model is likely to be difficult, as it would need to be adapted to produce results that apply to the different SMP operators. Such models would provide a deeper understanding of the cost structures of operators in Finland — and could help explain some differences between operators — and so would be useful tools in their own right. However, if they are to be used to set charges, they may need to be reconciled with the results produced by incumbents in order to increase FICORA's confidence in the models. In practice, this would be difficult to do in Finland given the current market structure. FICORA should, however, consider using existing cost models such as the FCC'S Hybrid Cost Proxy Model (and the adaptable model developed by this firm for DG Information Society of the EC) in order to see what is involved with developing such models.
- 5.21 As mentioned in the introduction, it is important to note that we do not comment on whether a CAS is needed, nor what its form and structure should be. These decisions would be made during the market reviews. In this section, we suggest options for reviewing the CAS in order to provide some confidence to FICORA (and other operators in the market) that any wholesale charges produced by the incumbent operator from these models, are reliable.
- 5.22 Our recommendation to FICORA is to develop a process or methodology to review the CAS produced by operators in Finland, in a way that is appropriate to the market circumstances in Finland. Many of the broad models for reviewing the CAS and setting interconnection charges discussed above would be difficult to implement in Finland, mainly because of the number of operators involved.
- 5.23 The large number of operators in Finland, however, provides opportunities as well as challenges for FICORA. It means that there are a number of data sources available that could be used to compare various costs and various prices. Moreover, the fact that the ownership and organisational structure of the operators differs also means that there will be some operators that could have a stronger tendency to self-regulate, and these could be used as a benchmark for some costs and prices in Finland.¹³
- 5.24 Finland should use its market structure to gain regulatory advantage. This could be done by, over time, collecting key cost information from operators in a consistent manner and then conducting its own comparative benchmarking to look for anomalies and (comparative) efficiency.

¹³ For example, if some operators are publicly or locally owned, they may not have a strong incentive to abuse their dominant position and might be considered as a useful guide for a fair and reasonable price.



5.25 There is precedence for such an approach in Europe and the United States. In the UK, for example, Ofwat — the regulatory authority for water services — reviews the performance of water companies against each other. In their Forward Work Programme, 1999-2000 and 2001-2002, for example, they stated that:

“Comparative or yardstick competition will continue to play a key role in our work because of the lack of direct competition.

We will publish annual reports on;

- financial performance and expenditure;
- levels of service; and,
- unit costs and efficiency.

We will identify the best and worst performers, and praise them or apply sanctions as appropriate.”

5.26 In the US, the FCC has set up the Automated Reporting Management Information System (ARMIS) to collect financial and operational data from the largest incumbent local exchange carriers. It also now includes service quality and network infrastructure information, video dial tone investment, and expense and revenue data.

5.27 **Our recommendation is to establish a process where prices for interconnection services and other outputs from the cost accounting systems developed by operators with SMP could be collected on a consistent basis and reviewed by FICORA.**

5.28 For any comparisons to be meaningful, however, the data need to be comparable. This does not necessarily mean completely consistent in every last detail, but at least capable of being compared. FICORA would need to do the following:

- (a) Issue a list of the prices and costs for which data should be provided. This list will depend on FICORA’s regulatory objectives, the findings in the market reviews, and the issues of concern in Finland;
- (b) Define the prices and costs clearly in order to avoid any misunderstandings;
- (c) Provide guidance of the principles or rules that should be used in order to produce the outputs. In the absence of this, the operators with SMP must clearly describe, document and justify the assumptions that they have made.

5.29 FICORA would continue their current policy of providing guidance or suggestions on the approach that should be followed by operators with SMP when developing their CAS, but this form of “yardstick” competition could help FICORA to review these systems in a more targeted and more effective manner.



- 5.30 This form of financial reporting could be used to present information on prices and costs of most regulated services, but particularly with interconnection and unbundled local loops. In the case of ULL, for example, operators with SMP would report their charges showing how charges were made up of separate cost components, such as the charge relating to the cost of the “raw copper”, the ULL specific costs, co-location charges (in as much detail as practical), and connection charges (by specific activity).
- 5.31 The information provided will be able to assist with the review of cost accounting systems in a number of ways, such as:
- (a) By alerting FICORA when an operator with SMP has made changes from one year to the next.
 - (b) By identifying outliers.
 - (c) By identifying which operators are producing low costs/prices and which are producing higher costs/prices.
- 5.32 In each of these cases, FICORA could launch an investigation to understand the reasons for differences, discrepancies and diversions. Over time, and as more information is collected, FICORA will develop a deeper understanding of the costs of SMP operators and on the main categories of costs behind interconnection and access products.
- 5.33 Comparing the prices of the interconnection services offered by operators with SMP — again in a regular and systematic fashion — would also be beneficial. Along with the prices, the operators would need to include a note describing the methodology used and a statement on why they believe that these prices are cost oriented. If FICORA had any concerns about any of the prices, then they could conduct a further exploration and request a view from the operator in question on why they believed that their prices varied from other operators in Finland.
- 5.34 **We would recommend that, over time, this information being made publicly available.** However, some of the cost data may raise confidentiality concerns. Further, subjecting this type of data to public scrutiny may stiffen opposition to such a scheme. It may, therefore, be more appropriate not to publish the data until the confidentiality concerns have been addressed and until the process is producing useful and comparable information. In the meantime, a comparison of the prices of interconnection services should be made publicly available.

Accounting separation

- 5.35 Accounting separation has been seen as useful in some, but not all Member States. Part of the reason for this ambivalence is that the need for separated accounts is not always clear. For example, some Member States believe that separated accounts are a way to identify if any unfair cross-subsidies are taking place. Others see them as an essential part of the regulator’s “tool box”, particularly when helping to verify whether charges are cost oriented.



5.36 Accounting separation is not necessarily expensive to implement. When operators with SMP have a very detailed CAS already in place, accounting separation can often be a way of presenting the final outputs of such a system. However, there is little point in requiring separated accounts unless there is a specific need for them and unless they will be a useful way of meeting regulatory objectives.

5.37 In other words, accounting separation could be implemented in a way that is effective but it will require clarity of regulatory objectives. For a country such as Finland - with multiple operators with SMP, multiple issues, and multiple objectives - this will be difficult to achieve.

5.38 Given that, **our recommendation to FICORA would be that if they decide to require operators with SMP to produce separated accounts then these should adhere to the requirements in the Access Directive.** In particular Article 11 states that:

A national regulatory authority may, in accordance with the provisions of Article 8, impose obligations for accounting separation in relation to specified activities related to interconnection and/or access.

In particular, a national regulatory authority may require a vertically integrated company to make transparent its wholesale prices and its internal transfer prices *inter alia* to ensure compliance where there is a requirement for non-discrimination under Article 10 or, where necessary, to prevent unfair cross-subsidy. National regulatory authorities may specify the format and accounting methodology to be used.

Without prejudice to Article 5 of Directive 2002/21/EC (Framework Directive), to facilitate the verification of compliance with obligations of transparency and non-discrimination, national regulatory authorities shall have the power to require that accounting records, including data on revenues received from third parties, are provided on request. National regulatory authorities may publish such information as would contribute to an open and competitive market, while respecting national and Community rules on commercial confidentiality.

5.39 All that is required, therefore, is the transfer *price* to be made transparent. This is a small, yet meaningful requirement. If the charge that the retail business of the SMP operator pays the network business of the SMP operator is made transparent, then FICORA, as well as other operators, could check to see whether the operator with SMP was complying with the principle of non-discrimination.

5.40 Article 11 is a narrower (yet more useful) approach to accounting separation than the approach in the 1997 Interconnection Directive. Article 8 (2) of that Directive required:

Member States shall require organizations operating public telecommunications networks and/or publicly available telecommunications services as set out in Parts 1 and 2 of Annex I and notified by national regulatory authorities as organizations having significant market power which provide public telecommunications networks and/or telecommunications services available for users and which offer interconnection services to other organizations, to keep separate accounts for, on the one hand, their activities related to interconnection - covering both interconnection services provided internally and



interconnection services provided to others - and, on the other hand, other activities, so as to identify all elements of **cost and revenue**, with the basis of their calculation and the detailed attribution methods used, related to their interconnection activity, including an itemized breakdown of fixed asset and structural costs.

Member States may choose not to apply the requirements referred to in the first subparagraph to organizations where their annual turnover in telecommunications activities in the Member States is less than the limit set in Part 2 of Annex VI.

- 5.41 The requirement for separated accounts to show costs and revenues (emboldened in the quotation above) has, therefore, been removed. The reasoning is not discussed, but we note that it has remained in Article 13 of the Framework Directive, which refers to undertakings providing public communications services that have special or exclusive rights for the provision of services in other sectors in the same or another Member State. Article 13 states:

Member States shall require undertakings providing public communications networks or publicly available electronic communications services which have special or exclusive rights for the provision of services in other sectors in the same or another Member State to:

- a Keep separate accounts for the activities associated with the provision of electronic communications networks or services, to the extent that would be required if these activities were carried out by legally independent companies, so as to identify all elements of **cost and revenue**, with the basis of their calculation and the detailed attribution methods used, related to their activities associated with the provision of electronic communications networks or services including an itemised breakdown of fixed asset and structural costs, or
- b Have structural separation for the activities associated with the provision of electronic communications networks or services.

Member States may choose not to apply the requirements referred to in the first subparagraph to undertakings the annual turnover of which in activities associated with electronic communications networks or services in the Member States is less than EUR 50 million.

- 5.42 The narrower approach to accounting separation can be rendered effective by making the transfer price transparent and allowing a comparison with charges in the operator's Reference Interconnect Offer (RIO). But it may not, on its own, provide sufficient confidence to FICORA that charges are cost oriented and include only appropriate costs. **In particular, FICORA will need to conduct additional checks to assess the reliability of the transfer price being shown in the separated accounts. Clear links, therefore, will be needed between the transfer charge (and the interconnect charge which should be similar) and the costs in the Cost Accounting System.** These links will be necessary to show that charges are cost oriented and that the operator with SMP is not discriminating between its own retail business and other operators.



Audits

- 5.43 The lessons regarding auditing of cost accounting systems and regulatory accounts that FICORA could learn from the five Member States reviewed were:
- (a) They can be useful, but in some cases counter-productive, because although they provided confidence that the accounts were “audited”, this assurance often deterred regulatory authorities from further investigation as they did not want to engage in a dispute with well resourced and experienced audit firms.
 - (b) The operators generally pay for the audit themselves (in Italy, the cost of the audit is indirectly borne by all operators). However, this is not necessarily bad if the regulator has confidence in the independence of the audit process and opinion.
 - (c) Audits are welcomed as they provide some comfort to NRAs, but they are not considered essential.
- 5.44 **Our recommendation to FICORA is to continue to require audits of accounts produced by operators with SMP. But the audit should include regulatory issues as well as financial issues.** The scope of the audit would depend on the size of the operator and the regulatory issue in question.
- 5.45 The scope of the audit could be as follows:
- (a) Reviewing that the transfer price and the prices for interconnection products are equivalent. Where these are not equivalent, the operator with SMP will need to explain the reasons for any divergences.
 - (b) Reconciling the prices for interconnection services with the appropriate network costs. The audit opinion would need to state that it has reviewed the source of the cost estimates and that these have been fairly prepared in accordance with any regulatory principles.
 - (c) Reconciling the regulatory accounts with statutory accounts.
- 5.46 The scope could vary for smaller operators, for example, by removing the requirement that they need to reconcile the regulatory accounts with statutory accounts.

Price Setting

- 5.47 Our view is that FICORA’s powers with regard to price setting need to be considerably strengthened. At present, their existing powers would not appear to allow FICORA to implement the new Directives in a meaningful and effective way. FICORA is not, for example, able to prescribe a CAS or to impose a particular price, even if such an action is necessary, proportionate and consistent with the spirit of the new Directives.



5.48 At the same time, we recognise that Finland does have a history of light handed regulation and we have, therefore, put forward a set of propositions for FICORA that would not be too intrusive to operators, whilst enable FICORA to regulate effectively when necessary. This means that clear ex-ante regulatory powers are needed to pre-empt any regulatory concerns.

5.49 The need for ex-ante regulation has been set out clearly by Ofcom, and the arguments made by Ofcom are worth examining in more detail in this section. In its review of the fixed geographic call termination markets (Consultation Document, 17 March 2003), Ofcom argues that:

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 markets in which competition is not effective, it is unlikely that ex-post general competition law powers would be sufficient to ensure that effective competition became established in markets such as those found in telecommunications. For example, ex-post powers prohibit the abuse of dominance rather than the holding of a dominant position. Ex-ante powers can be utilised to reduce the level of market power and thereby encourage effective competition to become established.

5.50 Ofcom used these ex-ante powers to regulate BT in the provision of its fixed geographic call termination services by requiring them to provide fixed geographic call termination on fair and reasonable terms; not to unduly discriminate in the provision of this service; to secure transparency through price publication; a requirement to set prices on the basis of long run incremental costs; requirements for separate accounting and appropriate cost-accounting systems; and price controls.

5.51 Price controls were seen as an important part of the way BT was to be regulated. Ofcom felt that without price control, there would be less incentive for BT to ensure that the costs of providing fixed geographic call termination services were efficiently incurred, as it would in any case receive its incurred costs plus an appropriate return on capital employed. Ofcom felt that the obligation on cost orientation (through LRIC) would not, on its own, constrain the level of costs that BT could incur to the efficient level, as it would maintain its profitability whether or not costs were efficiently incurred. Ofcom went on to argue that:

... a price control if appropriately designed is a proportionate response where competitive pressures and other regulation is not otherwise sufficient to ensure that prices are reflective of efficient costs. Charge controls (in particular RPI-X controls) create incentives for the charge-controlled firm to increase its efficiency and they thereby imitate the effect of a competitive market. The Director considers that (the continuation of) charge controls would create the incentives for BT to reduce costs. In BT's case, the charge control would address BT's SMP and the lack of competitive pressures to reduce costs; the risks of excessive costs and pricing that result; and the material adverse effects this would have on end-users.

5.52 But although other fixed network operators in the UK also have SMP in the market for providing fixed geographic call termination, the remedies imposed on them were less



onerous than on BT. In particular, they were only required to provide fixed geographic call termination on fair and reasonable terms. The Director thought that:

... the imposition of the full range of available regulatory remedies under the Communications Bill would place an additional burden on each regulated company and on the regulator. The requirement to publish a reference offer and regulatory accounts would also result in additional regulatory costs. The likely regulatory costs of this option would proportionately be greatest for the smallest fixed provider.

- 5.53 This statement has some applicability to the situation in Finland, but also some important differences. The 'other fixed network operators' in the UK are firms that have entered the market and have customers to which calls need to be terminated. The operators in Finland, on the other hand, are firms that have a SMP in their own geographic areas and can, therefore, be better categorised as small (in some cases, very small) BT's than 'other fixed network operators' in the UK sense. Nevertheless, the issue about size does matter and is discussed below.

Benchmarking and efficiency adjustments

- 5.54 Another power that should be made available to FICORA is the power to use benchmarks. Similarly, FICORA could make more use of efficiency adjustments when reviewing costs submitted by operators with SMP. We look at each of these powers in turn.

- 5.55 The use of benchmarks is discussed in the Access Directive. Article 13 of that Directive refers to price control and cost accounting obligations, and subsection 2 of that Article states that:

National regulatory authorities shall ensure that any cost recovery mechanism or pricing methodology that is mandated serves to promote efficiency and sustainable competition and maximise consumer benefits. In this regard national regulatory authorities may also take account of prices available in comparable competitive markets.

- 5.56 International benchmarks have been used by a number of Member States. For example, Agcom in 2003 reviewed the charge proposed by Telecom Italia and discussed a number of factors that were identified by other operators during the consultation exercise to explain the high ULL charge. In particular, other operators argued — and Agcom agreed — that the access network of TI was over-dimensioned in terms of copper pairs when these are compared to the number of lines in service. The level of spares was considered to be excessively high and this would affect capital costs associated with copper cable. Agcom also suggested that it would be appropriate to bring forward some of the efficiency improvements that TI will presumably achieve in the time horizon during which ULL charges will be regulated through the price-cap mechanism.



5.57 Agcom did not quantify the possible reductions associated with these two factors, but it did claim that they as a whole would be enough for TI to offer a wholesale charge that is in line with the best practice in Europe. Best practice in Europe was identified as being ULL charges in Denmark, i.e. € 8.30 per copper pair per month.¹⁴

5.58 The power to use efficiency adjustments is discussed in Article 13 of the Access Directive. Subsection 3 states that:

Where an operator has an obligation regarding the cost orientation of its prices, the burden of proof that charges are derived from costs including a reasonable rate of return on investment shall lie with the operator concerned. For the purpose of calculating the cost of efficient provision of services, national regulatory authorities may use cost accounting methods independent of those used by the undertaking. National regulatory authorities may require an operator to provide full justification for its prices, and may, where appropriate require prices to be adjusted.

5.59 Efficiency adjustments, which use cost accounting methods independent of those used by the undertaking, have been used by other Member States. For example:

(a) Ofcom compare the efficiency of BT against US operators in order to inform the “X” for their price control.

(b) ComReg has recently proposed to estimate operating costs for ULL based on an econometric study using costs from US LECs.

(c) Denmark has applied an efficiency adjustment to TDC’s operating costs used in the hybrid LRAIC model.

5.60 The power to make quite specific adjustments to prices using benchmarks or data independent of the undertaking is a useful and necessary part of the regulator’s tool-kit.

Price setting in the Finnish context

5.61 There is a risk that firms could set excessive prices in markets in which a network provider has SMP. Where such dominance was persistent, **FICORA should be able to implement a price control with transparent and easy to monitor compliance conditions to prevent the firm from abusing its SMP in the relevant market.** FICORA would also need the power to request data that would show that the firms are complying with their price control.

5.62 This is not to suggest that FICORA establish price controls for all — or indeed any — operators with SMP. This would, of course, depend on the findings of the market reviews. But it is important that FICORA have the ability or the possibility to impose a price control.

¹⁴ This charge excludes connection charges.



- 5.63 It may be that FICORA initially move to a regime that requires some operators with SMP in Finland to produce interconnection charges that were “fair and reasonable”. FICORA could then state that, initially at least, it would consider charges that were reciprocal as meeting this criteria. Encouraging operators to charge reciprocal termination rates would also have the added benefit of reducing the number of disputes among operators.¹⁵
- 5.64 One of the dangers with encouraging reciprocity is that operators might agree on high rates, which may distort competition at the retail level. Further, these rates may not necessarily be cost oriented and would therefore not send appropriate investment signals. However, it may be an option for smaller operators whose activities raise fewer concerns from a regulatory perspective and where FICORA would not expect agreements to lead to excessive prices.
- 5.65 Other operators, however, may need to be subject to more prescriptive regulation, such as the need for cost orientation. This is currently the case in Finland, and one way of reviewing the appropriateness of charges at present is to review the cost accounting systems developed by operators with SMP.
- 5.66 But under such a model, all that can be assessed is whether the prices reflect costs (somehow defined and measured). In the absence of a price control, there is little possibility of driving down costs (and prices) to efficient levels and no way of ensuring price reductions for the duration of the control period.
- 5.67 Our recommendation, therefore, **is that FICORA consider whether operators with SMP should be subject to different regulatory obligations regarding price setting.** We would also recommend that the following activities are implemented for those operators required to produce cost oriented charges:
- (a) FICORA should develop the “yardstick competition” model discussed earlier to help it identify areas for investigation;
 - (b) Subject to these reviews, the onus would be on operators with SMP to document and justify their proposed charges;
 - (c) But if there are concerns or issues with these charges, then FICORA could use one of the price setting powers referred to in the Access Directive. For example:
 - ▶ it could impose changes to prices to ensure cost orientation using benchmarking or other data where necessary; or

¹⁵ In the UK, reciprocity is seen as one way of ensuring that charges are “fair and reasonable”. However, Ofcom has an important benchmark against which to assess whether such charges are too high; BT’s costs. Ofcom is content to base reciprocal rates on BT’s costs (and not to allow agreements between other operators to exceed those costs), because it is confident that BT’s charges are based on increasingly efficient costs. BT’s costs are also increasingly transparent and subject to ongoing review (see Chapter 4).



- ▶ where there are concerns that operators with SMP are persistently charging excessive prices for services subject to review, it could implement a price control.
- 5.68 In this way, price controls could be used as last resort when operators with SMP are not complying with their obligations to produce cost oriented charges and also if FICORA is concerned about inefficient costs being passed through wholesale prices.¹⁶
- 5.69 The regulation of ULL provides one example of how these powers could be used. The operators with SMP would provide their charges broken down into their component parts (raw copper, ULL-specific costs, co-location, and connection). The assumptions and methodology behind these calculations would also be made available and the charges justified in a way that allows FICORA to determine whether costs are reasonable or cost oriented.
- 5.70 If FICORA — either through their own review or in response to divergences identified using the “yardstick competition” model discussed above — has doubts about these charges, then it could request further information. If it was not satisfied with the response, then it would use its powers to either set a benchmark or make adjustments and set such prices. FICORA would need to explain what it has done and provide an opportunity for the operator with SMP to incorporate such adjustments for the next time it proposed charges. In other words, the onus would remain on the operator with SMP to provide charges, but if these were not sufficiently documented and justified and if they were considered incapable of meeting FICORA’s policy objectives, FICORA would need to have the ability to enforce changes.

Resources

- 5.71 Although it is difficult to ensure absolute comparability between the tasks of economic regulation between NRAs and to make allowances for size and other relevant market developments, it does appear that FICORA is significantly under-resourced compared to the other NRAs reviewed as part of this study.
- 5.72 It is, however, difficult to identify what an “appropriate” complement of staff would be for an economic regulator of communications services in Finland and on what tasks they will be involved in. It might, however, be useful and interesting for FICORA conduct a “bottom-up” assessment of their own staff needs given their existing duties and also given an expanded set of duties more consistent with effective regulation. This could be contrasted with their existing number of staff and also with the experience from other regulatory authorities presented in this report.

¹⁶ In the current Communications Market Act (section 84) cost orientation and non-discrimination are the only pricing obligations recognised on the wholesale level. The use of additional price setting obligations would therefore be possible after the adequate powers are given to FICORA.



- 5.73 The major lessons for FICORA from our review of economic regulation in the five Member States are discussed below.
- 5.74 First, the issues facing an NRA will vary from Member State to Member State and will depend on the priorities set for regulation. This means that it is difficult to “match up” staff with particular functions as they change depending on the issues faced by the NRA. In Denmark and Sweden, for example, a significant amount of time and effort has been devoted recently to establishing their own cost models to calculate charges for access and interconnection on the basis of long run incremental costs. This effort should, in turn, reduce the effort required to review cost accounting systems of incumbent operators’ as the NRAs would hope to reduce their reliance on such methodologies for many interconnection services in the future.
- 5.75 Second, certain policy decisions will require considerable resources in order to implement the decision and set up the relevant processes. This means that whatever process for reviewing a CAS is put in place in Finland, considerable effort may be needed in order to establish such a methodology. But once a process has been put into place, then a smaller number of people could maintain and develop the process going forward. In the UK for example, around 2-3 people are involved in reviewing BT’s CAS on an on-going basis.
- 5.76 Third, the other NRAs reviewed in this study use external assistance in a number of ways, such as:
- (a) To provide academic advice on research papers or to support on legal disputes;
 - (b) To undertake specific and specialised tasks such as cost modelling to estimate the LRAIC for access and interconnection services;
 - (c) To conduct more detailed reviews of aspects of a CAS developed by an operator with SMP.
 - (d) To audit accounts produced by an operator with SMP.
- 5.77 The NRAs believed that external assistance was important, but noted that there were a “core set” of regulatory tasks, such as the market reviews and the general supervision or monitoring role, that could not easily be contracted out.
- 5.78 The NRAs did not specify the budget that was available for outsourcing, although many felt that if they could identify a need and justify the assistance, and then the money would be made available.
- 5.79 With regard to managing outsourced activities, in administrative terms, it is much easier to draw on consultants who have been pre-approved and have a framework agreement. It is also important to try to facilitate a knowledge transfer between consultants and staff.