

Adaptive regulation

1. Adaptive regulation is an alternative to Ofcom's proposal. Ofcom's approach essentially 'locks in' the areas of the UK where particular remedies apply for the whole charge control period. This brings a risk of regulatory failure – even if Ofcom can successfully choose the 'right' place to draw the boundary at first, this is likely to change over time, meaning that there will be a gap between the regulatory rules and underlying conditions of competition, distorting competition (and specifically, dissuading competitive investment in those areas). An 'adaptive regulation' regime could better serve the regulatory circumstances by adjusting in real time:
 - a) a cost-based *ex ante* price cap would be imposed on Openreach in potentially competitive areas at the start of the regulatory period;
 - b) this price cap would remain until a defined threshold is met for an area (e.g. an alt-net FTTP operator meets a specified coverage threshold in that area); and
 - c) at that point, Openreach would be required to keep their prices above a 'price floor' in that area.
2. We examine whether Ofcom has the legal powers to impose regulation in a form that varies automatically when the defined threshold is met.

UK law

3. At a high level, Ofcom's powers to impose SMP Conditions give it very broad discretion. The power is described at section 87(1) of the Communications Act 2003 (CA03):

'...[to] set such SMP conditions authorised by the section as they consider appropriate.'
4. Sections 87 and (in relation to charge controls) section 88 go on to set out detailed rules about the types of condition which may be imposed. They are detailed but they are broad. They are essentially enabling powers. Both of these sections are set out in full in Annex 1, but as a representative example (from section 87(9)(a)) Ofcom has the power to set:

'such price controls as OFCOM may direct in relation to matters connected with the provision of network access to the relevant network ...'
5. This is not a totally untrammelled power; but it is clear that it leaves the detail of the condition up to Ofcom.

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PARTNERS / MEMBERS: ROSALEEN HUBBARD, PAUL BRISBY, DAVID STEWART
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6. One possible limitation is the need for consultation/review when SMP conditions change. CA03 s 87(9) provides:
- ‘The SMP conditions authorised by this section also include ... conditions imposing on the dominant provider— (d) obligations to adjust prices in accordance with such directions given by OFCOM as they may consider appropriate.’
7. This envisages that changes to the price controls would be via a direction from Ofcom (i.e. an active step rather than a mechanistic one).¹
8. This reflects the position that economic regulation in electronic communications has tended to be more targeted and subject to greater legal constraints.² However, section 87(9) should not be read as preventing any adjustment to prices:
- a) First, it is only an enabling provision and does not purport to limit the type of SMP conditions that Ofcom may impose: as we have noted above, Ofcom’s powers to set SMP conditions are expressed in broad terms;
 - b) Secondly, it is clearly uncontroversial for price controls to change due to indexation, for example; indeed, arguably charge control SMP conditions would otherwise be inappropriately inflexible.
 - c) in the *TalkTalk* case the Court of Appeal decided that it was fair to allow Ofcom a significant degree of latitude when designing remedies for the whole period of a review.³ Although this was dealing with the “opposite” problem – the ossifying of remedies which remained constant – the key point is that Ofcom was, according to the court of appeal, entitled to take a view at the start of the control period which would be good for the whole period, apparently bypassing the substantive requirements for review (in section 86). By analogy from this case, there would be no reason why Ofcom would not be entitled to the same latitude when specifying an adaptive remedy.
9. Therefore, there is nothing explicit to exclude adaptive remedies. Indeed, it is evident that Ofcom considers that it does have the power to impose adaptive remedies. The use

¹ We have also considered s 86(1), which provides that Ofcom must not ‘set an SMP ... condition by a notification’ unless Ofcom performs a market review or decides there is no material change. However, in our view, this applies only to the *setting* of an SMP condition. It does not apply to the *operation* of an SMP condition – even if it operates to ‘flip’ an area between two different sets of remedies.

² We also note in passing that, even if the ‘automatic adjustment’ hurdle could be overcome, any SMP conditions would need to be sufficiently certain, so there was no ambiguity about when the pre-threshold price control applied, and when the post-threshold price control kicks in. This could be difficult given complexities about how to define a geographic area and to determine coverage. We think these difficulties could probably be addressed (e.g. if the threshold is defined by an Ofcom action, such as a determination that the threshold could be met). But this complexity could contribute to the difficulty in persuading Ofcom to adopt this course.

³ *TalkTalk v Ofcom and BSKyB* [2013] EWCA Civ 1318.

of a formula in price controls which varies the nominal prices based on an inflation factor is just that; as is (for example) cost of debt indexation. There is also nothing in the leading appeal case on the subject matter which implies a restriction on adaptive remedies.⁴ Accordingly:

- a) Ofcom's powers are very broad; and
- b) There is nothing which prohibits them; on the contrary, they are established regulatory practice.

10. This leads us to conclude that:

- a) Adaptive remedies are legitimate in principle;
- b) the simpler, more mechanical the updating process can be made, the more likely an adaptive remedy is to succeed; and
- c) Conversely, anything involving the exercise of any judgement is likely to involve an active intervention and rights of appeal.

EU law

11. We turn now to the terms of the European Electronic Communications Code (EECC).⁵

12. In broad terms, EECC art 68 requires that national regulatory authorities (NRAs):

- a) conduct period market reviews to determine whether an undertaking has significant market power; and
- b) impose obligations set out in the EECC (arts 69–74 and 76–80) as appropriate (or specifically request the EC to allow a different remedy).⁶

13. Market reviews have always been intended to be forward-looking, in the sense of taking into account likely market developments and this is now directly referred to in EECC art 67(2).⁷ However, in our view an 'adaptive regulation' proposal goes beyond this. It would not merely examine how a specific market is likely to develop over a three-year period, but instead involves setting up two different sets of remedies with merely a single criterion being used mechanistically to determine which of the two sets of remedies applies.

14. The issue of changing market dynamics is particularly important in the context of the EECC, given the potential length between market reviews has been extended from three to five years. In this respect, EECC recital 181 states that:

⁴ *TalkTalk v Ofcom and BskyB* [2013] EWCA Civ 1318.

⁵ The provisions of the EECC we refer to can be assumed to be reflected in relevantly similar terms in the current Common Regulatory Framework (CRF) unless we note otherwise.

⁶ See Access Directive art 8 and Framework Directive art 16.

⁷ This is not as clear in the words of the CRF - Framework Directive art 16 directs the market review to whether the relevant market *is* competitive.

'Reviews of obligations imposed on undertakings designated as having significant market power during the timeframe of a market analysis should allow national regulatory authorities to take into account the impact on competitive conditions of new developments... thus providing the flexibility which is particularly necessary in the context of longer regulatory cycles. In the absence of a single important change in the market but in the case of dynamic markets, it may be necessary to conduct a market analysis more often than every five years, for example not earlier than every three years as was the case until the date of application of this Directive. Markets should be considered to be dynamic if the technological evolution and end-user demand patterns are likely to evolve in such a way that the conclusions of the analysis would be superseded within the medium term for a significant group of geographic areas or of end-users within the geographic and product market defined by the national regulatory authority'

15. Similarly, EEC art 68(6) provides that NRAs:

'shall consider the impact of new market developments ... influencing competitive dynamics. If those developments are not sufficiently important to require a new market analysis ... the [NRA] shall assess without delay whether it is necessary to review the obligations imposed ... and amend any previous decision ... Such amendments shall be imposed only after consultations in accordance with Articles 23 and 32.'

16. There is a good case that an 'adaptive regulation' regime:

- a) Provides more appropriate remedies than a 'static regime'. While Ofcom will necessarily be choosing 'trigger factors' which are rough proxies for determining the actual level of competition, this is still an improvement from a situation where areas are 'locked in' for the full charge control period, regardless of how actual competitive dynamics may change;
- b) Provides better stability than alternatives such as a mid-period review, because market participants will know up-front what the two sets of remedies are, and the criteria used to determine the regulatory areas. A mid-period review, in comparison, could lead to an entirely new and unpredictable set of remedies and could take into account any number of factors; and
- c) Is more transparent: Ofcom will be fully consulting on the set of remedies and the criterion to be taken into account up-front, which will also fulfil its duties of procedural fairness.