

Regulatory stability and the challenges of re-regulating

A CERRE study

Robert Baldwin

With contributions by Peter Alexiadis, Paulius Mencas, Jon Stern

Edited by Martin Cave

4 February 2013

130204_CERRE_Study_Stability_Final



Table of content

About CERRE.....	4
About the authors.....	5
About the editor	6
1. Introduction	7
1. 1. Controls	7
1. 2. Timescales	8
1. 3. Tractability.....	8
2. Sources of change, strategies of control and evaluation	11
2. 1. Sources of change	11
2. 2. Varieties of re-regulation strategies	14
2. 3. The gains and losses of re-regulation	16
2. 4. Re-regulation: the legal issues	19
3. Regulatory stability: the impact of European legislation	34
3. 1. Telecommunications	35
3. 2. Energy.....	36
3. 3. Railways.....	36
3. 4. Postal services	37
3. 5. How much regulatory instability is involved?	37
4. Three Case Studies on Re-regulation	39
4. 1. European telecommunications: potential changes to the regulatory regime..	39
4. 1. 1. Introduction.....	39
4. 1. 2. The aftermath of 2009 amendments to the Framework.....	46
4. 2. The New Zealand experiment: legislating for term assurance	52
4. 2. 1. The “input methodologies”	53
4. 2. 2. Designing the methodologies	55
4. 2. 3. Evaluation.....	56
4. 3. Commitment to the valuation of sunk assets: the Regulatory Asset Base ...	57
4. 3. 1. Introduction.....	57



- 4. 3. 2. The evolution and development of RABs.....59
- 4. 3. 3. RABs in the UK and other member states..... 60
- 4. 3. 4. RABs as a protection against asset stranding 62
- 4. 3. 5. Evidence on the effectiveness of the RAB as a commitment device. 64
- 4. 3. 6. Summary 65
- 5. Conclusions67**
- Appendix 1 - A review of examples of re-regulation strategies..... i**
- Appendix 2 - Competition law as an adjunct or obstacle to regulatory certainty: the energy sector as a case study i**

Table of tables

- Table 1: Sources of change..... 14
- Table 2: Sources of change and potential re-regulation strategies 16
- Table 3: Expected costs of a re-regulation strategy in relation to a source of change 19
- Table 4: Susceptibility to legal challenge of re-regulation strategies 31
- Table 5: Regulatory characteristics of RAB energy regimes in four EU countries..... 61



About CERRE

Providing studies, training and dissemination activities, the Centre on Regulation in Europe (CERRE) promotes robust and consistent regulation in Europe's network industries. CERRE's members are regulatory authorities and operators in those industries as well as universities.

CERRE's added value is based on:

- its original, multidisciplinary and cross sector approach;
- the widely acknowledged academic credentials and policy experience of its team and associated staff members;
- its scientific independence and impartiality.

CERRE's activities include contributions to the development of norms, standards and policy Recommendations related to the regulation of service providers, to the specification of market rules and to improvements in the management of infrastructure in a changing political, economic, technological and social environment. CERRE's work also aims at clarifying the respective roles of market operators, governments and regulatory authorities, as well as at strengthening the expertise of the latter, since in many member states, regulators are part of a relatively recent profession.

This study has received the financial support of CERRE members. As provided for in the association's by-laws, it has been prepared in complete academic independence. The contents and opinions expressed reflect only the authors' views and in no way bind the members of CERRE (www.cerre.eu).



About the authors

Robert Baldwin is a Professor of Law at the London School of Economics and Political Science, where he teaches Regulation and Criminal Law. He has written numerous books and articles on regulation, including the most widely used academic volume on regulation in the UK: R Baldwin, M Cave and M Lodge, *Understanding Regulation* (Oxford University Press, 2nd edition, 2011).

He is an advisor on regulation to numerous international bodies, government departments and agencies and corporations, and also a member of the National Audit Office's Panel of Regulatory Experts.

Peter Alexiadis is a Solicitor of the High Court of England and Wales and is the Partner-in-Charge of the Brussels office of Gibson, Dunn & Crutcher LLP. He has postgraduate legal qualifications from the LSE, Sydney and Thessaloniki Universities, and has been practicing EU law in Brussels since 1989. He specializes in competition and communications law as well as in regulatory policy in the telecommunications sector. He also regularly counsels government ministries in their development of regulatory policy and sector-specific regulators in their application of regulatory obligations. He is consistently rated by the various peer reviews as one of the leading practitioners in those fields. He has for a number of years been the Course Coordinator and senior lecturer in the Kings College LLM course entitled "Competition Law and Regulated Network Sectors".

Paulius Mencas is a Lithuanian lawyer who holds an LL.M from King's College London and Bachelors and Masters degrees in Law from Vilnius University. Having completed a traineeship with the European Commission's Directorate General for Competition, he is currently working in the Brussels office of Gibson, Dunn & Crutcher LLP, where his practice primarily focuses on competition law and regulation of network industries.

Jon Stern is a Senior Advisor at CEPA (Cambridge Economic Policy Associates) and a founder member of the Centre for Competition and Regulatory Policy at the City University in London.

For over 15 years, Jon Stern was a Senior Consultant and Special Adviser at NERA, where he worked primarily on energy sector and utility reform, restructuring and regulation, initially in Central and Eastern Europe, Asia and Africa. Jon Stern has regularly worked as a consultant to the World Bank on energy sector and other infrastructure industry regulatory and restructuring issues. Prof. Stern has been an expert witness to the House of Lords Select Committee on Regulators and an expert adviser to the Jamaican Office of Utility Regulation.



CENTRE ON REGULATION IN EUROPE

About the editor

Martin Cave, OBE, is a Joint Academic Director of CERRE and also Visiting Professor at Imperial College in London. In 2011/12 he was holder of the BP Centennial Chair at the London School of Economics and Political Science and before that a Professor and Director of Warwick Business School's Centre for Management under Regulation. He is an economist specialising in the regulation of network industries.

Prof. Cave has been heavily involved in providing advice on these matters to the UK and other governments and to the European Commission.

Since January 2012, he has been a Deputy Chair of the UK's Competition Commission.

1. Introduction

“Everyone wants regulation to be stable – unless they think it is bad regulation, when they want it changed at once.”

This statement crystallizes the dilemma that this report will examine. It points to the narrowness of the path that regulators have to tread. On the one hand, they have to offer stability so as to allow regulated businesses to plan activities and investments without being buffeted by unnecessary uncertainties. On the other hand, they have to be responsive and malleable so that they can adapt to new market conditions, encourage innovation, facilitate provider responsiveness, and offer regulatory improvements and adjustments to address any imperfections in the current regime.

This report considers how regulators can develop strategies for ‘re-regulating’ – that is adjusting their regimes and controlling both the processes and rates of change so as to reconcile demands for both stability and responsiveness. A major focus of the study will be how to identify, quantify and balance the gains and the losses of stability – gains when good regulation is maintained, but losses when poor regulation goes uncorrected.

The study will also examine in detail the strategies that regulators can use to deal with change (taking examples from various sectors), the challenges that flow from supra-national legislation and the legal issues to which regulatory changes potentially give rise. Thus, it will look at the special impact of new European requirements and it will examine particular case studies in some detail.

Before going further, however, it is necessary to be clear about the concept of ‘regulatory stability’. We suggest that, when examining the stability of a regulatory regime, it is useful to think of this with reference to three aspects: controls; timescales; and tractability.

1.1. Controls

A regime is ‘stable’ in the narrow sense when the different sources of control (including incentives) remain constant over time. Thus legal rules, their interpretations, codes and modes of intervention do not vary, nor do modes of calculation that affect controls – such as methods of calculating costs of capital. (These different elements of control are discussed further in section 2 in looking at sources of regulatory change.) It follows that a regime may vary in stability across different elements of control. Thus, its statute law, delegated legislation and codes of practice may be quite stable but it may vacillate regarding modes of intervention or accounting methodologies.

It is possible to think of three different levels of change in the tools of control.¹ First-order changes involve adjustments to existing tools – as where the X in an RPI-X price cap is altered. Second-order changes involve the adoption of new tools or control mechanisms – as where there is a move from RPI-X to rate of return regulation. Finally, third-order changes involve paradigm shifts and fundamental transformations in structures or techniques – as where there is a move to renationalise or a change from discretionary licence allocations to auctions or from command-and-control regulation to market instruments such as tradable permits.

The relationship between stability in respect of these different levels is a complex one. Thus, adhering blindly to a dysfunctional price control – for example, one which led to firm bankruptcies or which allowed transparent gaming of the control by the regulated firm – might lead to instability in the regulatory system as a whole. Adaptation at the level of more micro controls might enhance macro stability.

1. 2. Timescales

A regulatory regime's stability is relative and cannot be judged according to a single timeframe. It falls to be judged with reference to the timescales that are relevant within the processes of service delivery. Thus, stability for the purposes of structural financial planning, or the design of infrastructures, is long-term in nature and a 'stable' regime may be one that is unchanging for numbers of years. In contrast, stability in methods of calculating costs may be judged according to shorter timescales. Thus, stability with respect to the different levels of control defined above is associated with different timescales – the value of X within a price control with respect to the control's duration; a switch in the form of regulation over a longer period; a fundamental transformation, for example a commitment to shift from regulation of an end-to-end monopoly to liberalisation or unbundling will play out over a yet longer timescale.

1. 3. Tractability

Closely related to issues of timing are matters of tractability. From a tractability perspective, a regime that is 'stable', in the broader sense, is not so much one in which there are no changes as one in which the changes that occur are knowable or foreseeable and governable. A process of change is liable to be seen as the less unstable in so far as it can be easily planned for and managed. Thus a planned

¹ See J. Black, M. Lodge and M. Thatcher, *Regulatory Innovation* (Elgar, 2005) pp. 9-11.

programme of developments which involves a high level of advanced disclosure may be thought of as highly tractable and stable even though it allows numbers of regulatory changes to be effected. In contrast, a regime that introduces retrospective measures or unannounced changes will be thought of as highly unstable in so far as it imposes shocks and surprise impacts on regulated firms.

An important aspect of tractability is, furthermore, intelligibility. Being able to predict changes will only take regulated firms so far. They, and other parties, will often want also to understand why regulatory changes have been made. This is because understanding the reasons, assumptions, calculations and policies that underlie regulatory movements is often essential to contextualising changes and calculating how these and associated developments are to be managed. This is why those who are affected by regulation are generally very concerned that regulatory changes are explained and documented in a transparent manner.

Different re-regulation strategies have different potential to render changes tractable, as will be discussed below.

In summary, it can be argued that a regulatory system is optimally stable if its various modes of control are adjusted at appropriate timescales with sufficient predictability and if such adjustments can be responded to by regulated firms and the beneficiaries of regulation without undue resource implications. As for the challenges of judging when timescales or resource implications are appropriate or undue, these are matters to be returned to below.

Section 2 below outlines the different sources of regulatory change that are commonly encountered and it looks at the variety of re-regulation strategies that may be used to control such changes. It notes the various sources of change that are potentially addressable with the outlined strategies before suggesting a method of assessing the gains and losses that are associated with a given re-regulation approach. It also looks at the legal issues potentially posed by different re-regulation strategies.

In Europe, very special problems of stability tend to be associated with the emergence, in a number of sectors, of packages of reforming legislation. The importance of these packages in industries such as telecommunications, energy and railways prompts a consideration of their impact in Section 3.

Attention then turns, in Section 4, to case studies of major efforts to re-regulate by using novel tools. It reviews the management of potential changes to the European telecommunications regulatory regime; the New Zealand experiment in legislating for what below we call “term assurance”; and the commitment by regulators to a valuation of assets within a Regulatory Asset Base.



Section 5 draws conclusions on potential responses to the challenges of regulatory change.

Appendix 1 throws light on the variety of re-regulation strategies that can be deployed. It details fifty examples of major re-regulation strategies that are revealed when surveying a number of European jurisdictions. Appendix 2 examines the role of competition law and policy in influencing regulatory stability.

2. Sources of change, strategies of control and evaluation

The aim of a re-regulation strategy, it is suggested here, is to maximise the excess of benefits over expected costs relating to regulatory change. That is not to suggest, however, that it is feasible to use formal cost-benefit analysis to evaluate re-regulation strategies. Informational and resource constraints rule this out since any given re-regulation strategy will affect numbers of different sources of regulatory change (e.g. changes in laws or in administrative methods of calculating regulated firms' costs) and it will involve considerable numbers of 'stability benefits' and 'unresponsiveness costs'.

If the value of a re-regulation strategy is to be assessed, therefore, judgements have to be made within an appropriate framework. That framework is provided by being clear about three issues:

- *Sources of change* – the factors that will trigger regulatory changes;
- *Varieties of re-regulation strategy* – the kinds of technique that can be used to manage regulatory adjustments;
- *The gains and losses* – the varieties of costs and benefits that are caused by shifts in regulation and the degree to which these are controllable by different re-regulation strategies.

Once there is clarity on the above fronts, it becomes possible to make judgements on the gains and losses that can be expected to be associated with different re-regulation strategies. It will be assumed here that gains and losses can be calculated with reference to the objectives for a regulatory regime that are established by the relevant legislation. A mis-targeted outcome can thus be judged on this basis – as where an error in a price-cap mechanism produces either excessive charges to consumers or unreasonably low returns to the utility providers. Benefits and costs, of course may fall on different parties, be these providers, consumers, or citizens more generally and all such factors will be considered below.

Finally, attention has to be paid to the legal issues that may arise when a particular re-regulation strategy is sought to be deployed. The variety of these is considered in the fourth sub-section below.

2. 1. Sources of change

Changes in regulation can flow from a number of sources. The relevant legal rules may be altered, or new approaches and interpretations may be adopted in applying the rules. Innovations may be adopted in dealing with costs or in methods of

calculating such matters as allowable financial returns. As noted, these changes may impose costs as well as generate benefits, and they may do so in ways that are quite issue-specific.

A first source of change is the advent of *new rules of primary legislation*. These new rules may stem from domestic legislatures or from supra-national bodies such as the European Union. They may institute fundamental, third-order changes, such as changed regulatory objectives or completely new modes of regulating. They may, however, effect lesser transformations. A second source of change is the *new interpretations of rules*. New interpretations of existing laws, codes or objectives may be instituted as the result of reviews (by regulators, supra-national bodies or domestic governments) or through court decisions that give new meanings to legal requirements. A third source of change is the new item of *delegated legislation or code of practice*. Fresh rules may be issued by regulators or Ministers as, say, statutory instruments and these may change the law (subject to statutorily mandated procedures). Alternatively, new guidelines, codes of practice, handbooks or other informal rules and statements may stop short of changing the formal law but they may lead regulators in practice to adopt new methods – for example of calculating costs of capital for the purposes of setting price caps.

Implementation / Intervention Strategies may also be revised in ways that change the regulatory game considerably. Enforcement philosophies and procedures may change. Regulators may adopt new methods of intervening in the activities of the regulated firms – they may, for instance, change the periods for collecting and delivering data or for assessing and adjusting the performance of the firms. (For example, the regulator may institute monthly, instead of quarterly, reviews of the firms, or impose additional targets.). They may change the ways in which they identify problems or risks – by, for example, paying increased attention to consumer sensitivities when establishing priorities for attention.

In similar fashion *regulatory processes and intervention styles* may be adjusted in a manner that creates costs and benefits. Regulators may, for instance, change the ways in which they communicate with regulated firms – they may stop issuing general instructions on modes of compliance and move to a process in which they reduce their own costs by reacting to the behaviour of regulated firms. Regulators may also vary the timing schedules that they employ in responding to firms or in taking operational steps to deal with industry challenges, or in addressing the possibilities of estimation errors.²

² Henry Ergas, Jeremy Hornby, Iain Little and John Small, *Regulatory Risk*, A paper prepared for the ACCC

For many regulated firms, central issues are the *data systems and costing methods* that are used by regulators. Changes in these systems and methods may give rise to considerable costs (and sometimes benefits) and they may be effected by administrative means. Regulators may, thus, change the nature of the data to be supplied by firms. They may change the assumptions, principles, methodologies and allowances they employ when calculating such matters as appropriate returns or costs of capital. They may also change the assumptions and methods that they employ in calculating risks or in distributing risks between different involved parties.

Resource inputs (such as staff levels, etc.) may alter and this may occasion new costs and benefits— when, for instance, the regulator cuts staff levels in departments that assist with compliance, the firms may have to devote considerably greater resources to achieving forms of compliance that satisfy the regulator. Similarly facilitative *services* may be revised, as where there are new policies on advice and communications or where regulators change their approaches to advising firms on modes of compliance. Such changes may create new uncertainties and costs, or, in the alternative, improved services and attendant benefits. Finally, a further factor that may cause new costs and benefits is *institutional shift*. This may occur when there is reform of the regulator’s organizational structure. The regulatory body may change its own institutional format, its internal management regime, or its links with other regulatory institutions, and this may impact on firms and others beyond the regulator.³ If, moreover, a regulatory body operates with limited institutional memory and consistency of approach, a change of decision-making or policy-making personnel may prove challenging to those affected by the ensuing institutional shift and the change of approach taken by the agency.

An important aspect of institutional shift is a change in institutional leadership. Many regulatory regimes are complex, fragmented and ‘decentred’⁴ in so far as they involve numbers of regulators who act concurrently to control an issue. These regulators may be sited at different levels of government (e.g. Member State or EU level) and they may vary in nature, with some being public departments or agencies, some being associational self-regulators and some being private, contractually-established or other kinds of body. Regulatory changes are often instituted when there is a movement in the regulator that takes control over an issue (as when the European Commission issues a new item of soft law that prevails over the position being adopted by a member state regulator). Low tractability occurs when regulated firms are surprised by the new directions, interpretations and demands that are the

Regulation and Investment Conference, Manly, 26-27 March 2001.

³ See J. Black, M. Lodge and M. Thatcher, *Regulatory Innovation* (Elgar, 2005) pp. 11-12.

⁴ See J. Black, ‘Decentring Regulation’ (2001) 54 *Current Legal Problems* 103-147.

products of such control shifts – the problem was captured by one representative of a regulated European telecommunications firm who commented on one aspect of European telecommunications regulation: ‘You never know who will lead the dance.’

The major such sources can be summarised as in Table 1.

Table 1: Sources of change

Rules of primary legislation
Interpretations of rules
Delegated legislation and codes, etc.
Implementation / intervention strategies
Regulatory processes and intervention styles
Data systems, costing methods
Resource inputs (staff levels, etc.)
Facilitative services
Organizational structures, institutional shift

2. 2. Varieties of re-regulation strategies

Regulators around the world have sought to apply a number of re-regulation strategies. Some of these involve an emphasis on controlling the probability that a given change will take place (as when firms are given an undertaking that legal or administrative requirements will not be revised within a given period). Other strategies (such as assurances of advance notice or consultation) focus on limiting the costs that occur as a result of any changes that occur within the regulatory regime.

Appendix 1 reviews fifty examples of the major devices that have been adopted in six EU member states.⁵ This review serves to indicate the considerable variety of available mechanisms that can be organised under the headings:

- *Term assurance;*
- *Notice and information;*
- *Negotiations and compliance discussions;*
- *Transition programmes, timescales and reviews;*
- *Parallel concessions and compensation;*
- *Flexibilities;*
- *Advice, guidance and assurance.*

⁵ The Appendix focuses on experience in the utilities sectors in: Spain, Portugal, the United Kingdom, Italy, Ireland and France. (Illustrations of strategies are given, rather than an exhaustive analysis.)

Term assurance is a strategy that typically involves regulators or governments undertaking not to change certain factor (e.g. primary legislation or a mode of intervention) within a specified period of time. This can range from a commitment to a price path in a price control to the more general commitment on regulatory principles.

In a *notice and information* approach the regulators undertake to give notice to firms when they are contemplating changes. A central aim is to render changes more tractable and to avoid the costs associated with shock or surprise changes that firms find expensive to adjust to at short notice.

In the third strategy, *negotiations and compliance discussions*, the regulators address the tractability issue by going beyond the giving of notice. They do so by offering firms the opportunity to suggest ways in which changes can be effected so as to reduce adjustment costs or increase consumer benefits. Regulators may also assist the firms to plan for change so as to reduce adjustment costs. They may additionally offer firm assistance by negotiating about desired outcomes which cannot be easily achieved using existing technologies and business practices.

A related, fourth strategy involves *transition programmes, timescales and reviews*. In these processes, tractability is served when the regulators implement changes by stages and indicate the timescales by which compliance has to be achieved incrementally. They may also undertake to review regulatory approaches periodically so as to reduce the costs of over-inclusiveness (e.g. the costs created by regulatory constraints that involve undue compliance costs or prevent the exploitation of markets).⁶

More radically, regulators can reduce the unwanted impacts of regime change by allowing changes to be compensated for by balancing concessions.⁷ For example, in July 2012, the European Commission Vice President in charge of the Digital Agenda announced a regulatory change which disappointed alternative operators' hopes with respect to one matter, but offered a concession in relation to another.⁸ This strategy of *parallel concessions and compensation* may reduce overall costs by

⁶ See the discussion at BERR Economics Paper No. 4 *Regulation and innovation: evidence and policy implications* (BERR, December 2008) p. 45.

⁷ See J. Quinn and M. J. Trebilcock, *Compensation, 'Transition Costs, and Regulatory Change'* (1982) 32 *University of Toronto Law Journal* 117-175; G. Tulloch, 'Achieving De-regulation: A Public Choice Perspective' *Regulation* (Nov. 1978).

⁸ Refer to MEMO/12/554 – "Enhancing the broadband investment environment – policy statement by Vice President Kroes". The concrete application of the announced policy statements and amendments is due to be reflected in the form of regulatory guidance found in new Commission Recommendation on consistent non-discrimination obligations and costing methodologies whose final version is expected to be published early 2013. For further discussion see section 3.1 below.

lowering the frictions involved in a move to a new scenario.

In similar vein, regulators may provide businesses with *flexibilities* on compliance and allow them some freedom of scope regarding the means chosen to deliver desired policy outcomes.

The final major strategy of re-regulation to be noted is again one that deals with tractability. It is that of *advice, guidance and assurance*. In this approach, the regulators seek to ease transitional difficulties and uncertainties by delivering (or assuring regulated businesses that they will issue) advice or guidelines on new compliance requirements or other regulatory changes. A central aim here is to limit regulatory risks by ensuring a high level of knowledge regarding the behaviour that the regulator will deem to be compliant.

The various sources of regulatory change can potentially be addressed by the various re-regulation strategies discussed. Table 2, accordingly, summarises the nine sources of regulatory change and the seven major re-regulation strategies that may, subject to context, have a role in addressing these.

Table 2: Sources of change and potential re-regulation strategies

Sources of change	Re-regulation strategies
<ul style="list-style-type: none"> • Rules of primary legislation • Interpretations of rules • Delegated legislation and codes etc. • Implementation / intervention strategies • Regulatory processes and intervention styles • Data systems, costing methods • Resource inputs (staff levels, etc.) • Facilitative services • Organizational structures, Institutional shift 	<ul style="list-style-type: none"> • Term assurance • Notice and Information • Negotiations and compliance discussions • Transition programmes, timescales and reviews • Parallel concessions and compensation • Flexibilities • Advice, guidance and assurance

2. 3. The gains and losses of re-regulation

Different costs and benefits are associated with changes in regulatory regimes. In the first instance, *capital costs* will tend to increase when firms face regulatory uncertainties. Such firms will be unable to assure investors that current market conditions and costs will be sustained over lengthy periods and this will tend to increase the price at which finance is raised. For similar reasons, *planning costs* will tend to increase because uncertainties will reduce horizons and will mean that there

will be a number of scenarios and contingencies for which planning is required.

A category of direct costs from regulatory change is *implementation / transition*⁹ and *adaptive costs*. Examples of such costs might be retraining programmes to cope with new rules or compliance demands or data requirements. Compliance cost effects may also include the impacts of a change on consistency with other governmental controls and incentives.^{10 11}

Losses may also occur where the value of assets sinks because of regulatory changes – as when an investment has been made in order to satisfy a now defunct compliance requirement. A further cost of regulatory change may be *delay*. Thus, a firm may be slow to develop products and markets because it awaits certainty on new regulatory requirements.

Regulated concerns will, moreover, incur *process costs* when they deal with new regulatory rules and procedures. Resources, for instance will be consumed in discussions with the regulator when and as these are needed to adjust to new approaches). Such costs, of course, may be balanced, in some contexts, by *process benefits* – as where regulatory changes increase transparency, openness and accountability.

Looking to the need for regulation to achieve the right targeted outcomes, there are costs associated with *under-inclusiveness* when changes mean that undesirable behaviour is not prevented – e.g., as occurs when excess profits are uncontrolled. Similarly, there may be problems of *over-inclusiveness* when changes mean that desirable behaviour is excessively discouraged – as when price controls unfair or unduly constrain investment.

Effects on competition or the development of new markets may also constitute costs of change. A regulatory change may either impede or promote innovation in businesses or responsiveness to markets.¹² Regulatory uncertainties may also

⁹ See J. Quinn and M. J. Trebilcock, 'Compensation, Transition Costs, and Regulatory Change' (1982) 32 *University of Toronto Law Journal* 117-175; Dorfman, *Agenda for Research on the Transitional Effects of Regulation* Report of Washington DC Conference (June 1978).

¹⁰ Kivimaa, P. (2008) "The innovation effects of environmental policies: linking policies, companies and innovations in the Nordic pulp and paper industry".

¹¹ On corporate reactions to regulatory change and uncertainty see, e.g.: Christian Engau • Volker H. Hoffmann, 'Corporate response strategies to regulatory uncertainty: evidence from uncertainty about post-Kyoto regulation' (2011) 44 *Policy Sciences* 53–80; Collis, D. (1992). 'The strategic management of uncertainty' (1992) 10(2). *European Management Journal* 125–135; Courtney, H., Kirkland, J., & Viguerie, P. (1997). Strategy under uncertainty. (1997) 75(6) *Harvard Business Review* 67–79; Volker H. Hoffmann Thomas Trautmann and Jens Hamprecht, 'Regulatory Uncertainty: A Reason to Postpone Investments? Not Necessarily' (2009) 46(7) *Journal of Management Studies* 1227–1253.

¹² See BERR Economics Paper No. 4 *Regulation and innovation: evidence and policy implications* (BERR, December 2008). Department for Innovation, Universities and Skills (DIUS), *Helping Regulators to Promote Innovation* (2008). Ashford, N.A., Ayers, C. and Stone, R.F. (1985) "Using regulation to change the market for innovation" in

discourage entry from new operators and this may reduce competition and consumer welfare.

A final category of expense is that of *sanctioning costs*. These may occur not merely when a firm is fined for non-compliance, but they may also arise when a failure to adjust to a change produces effects such as: exclusions from markets; suspensions for the business and individuals; bans for the business and individuals; personal liability for senior managers and compliance staff; stakeholder lawsuits; client lawsuits; remedial consulting; commitment to more resources to assist compliance; additional reporting; legal fees; and heightened scrutiny by auditors and examiners on future inspections.

Having identified the principal costs and benefits that are associated with changes in regulatory regimes, it is then possible to estimate, more specifically, the costs and benefits that are likely to be associated with a given combination of particular *sources of change* as they are affected by a given re-regulation strategy (see Table 3 below). In a world of perfect information and unlimited calculative resources, the various costs and benefits attached to those combinations could be assessed by looking at their probabilities and quanta. As noted at the start, however, it is not feasible to conduct detailed, quantified, analyses of the myriad costs and benefits of a variety of re-regulation strategies as these affect different sources of change. What can be offered here, though, is a framework for making judgements about different re-regulation strategies, one that serves to identify the key considerations to be taken into account in judging the potential gains and losses associated with a re-regulation strategy that is adopted in a given area.

Table 3 sets down such a framework. It takes a given combination of source of change and re-regulation strategy and prompts consideration of the major gains and losses to be expected from that combination. In the example offered, the source of change is primary legislation and the re-regulation strategy is term assurance. A similar framework could be applied to any combination of the nine sources of change set out in Table 1 and the seven re-regulation strategies of Table 2.

Harvard Environmental Law Review Vol 9, No 2, p419-466. Businesses may innovate with respect to products but also by developing new organisational structures and business models, adopting new management practices and combining existing technologies and processes in new ways. On regulatory uncertainties and negative effects on innovation, see Marcus, A.A. (1981) "Policy uncertainty and technological innovation" in Academy of Management Review Vol 6, No 3, pp 443-448. On regulatory lag and costs see: P.L. Joskow, D. R. Bohi and F. M. Gollop 'Regulatory Failure, Regulatory Reform, and Structural Change in the Electrical Power Industry' (1989) Brookings Papers on Economic Activity. Microeconomics 125-208

Table 3: Expected costs of a re-regulation strategy in relation to a source of change

	Re-regulation strategy: term of assurance
Source of change: primary legislation	Capital costs
	Planning costs
	Implementation / transition and adaptive costs
	Delay
	Process costs
	Process benefits
	Under-inclusiveness
	Over-inclusiveness
	Effects on competition or the development of new markets
	Sanctioning costs

2. 4. Re-regulation: the legal issues

In adopting any re-regulation strategy, a sector-specific regulator needs to consider carefully the legality of its proposed approach and the vulnerability of that proposed approach to legal challenge by disaffected stakeholders. In this regard, regard must be had to a variety of different avenues of legal challenge that might arise, whether at national level or as a result of EU law obligations that must be implemented locally, or even in the context of international treaty obligations.

- *Introduction: scope of legal challenge and the intensity of regulatory change*

As a preliminary matter, the extent and intensity of potential legal challenges may vary, potentially significantly, with respect to the level of change brought about by any particular act of re-regulation. Accordingly, the first, second and third order changes referred to previously would be confronted with a different set of potential challenges to their legality. For example, whereas the “third order” changes would be subject to the broadest set of possible legal avenues of challenge, by contrast the first order changes would be vulnerable to the narrowest set of grounds for legal challenge.

Potential legal challenges might also vary depending on the particular form and source of the re-regulation under review. Of particular relevance might be the issue of whether re-regulation takes place at the supra-national (EU) or at the national level.¹³ In addition, the question of which regulatory instruments in the legal hierarchy are being used to effect re-regulation, namely, whether they are primary

¹³ As regards the form and source of re-regulation, a notable feature of EU-law based regulatory frameworks is that re-regulation on the EU level would normally entail the implementation of the re-regulatory measures also at Member State level, thereby requiring a “two-layered” assessment of re-regulation legality.

law instruments¹⁴ that are used to establish a regulatory framework, implementing by-laws that are used to inject greater detail into the regulatory process, or non-mandatory “soft law” instruments that are used to effect regular change, will also be of considerable importance.

Thus, the degree of legal change effected by the re-regulation, on the one hand, and the form and source of that re-regulation, on the other, are elements which interact with one another, insofar as the level of regulatory change should in general be reflected in the particular forms and sources of re-regulation.¹⁵ Such an interaction is also reasonable and necessary, as different forms and sources of re-regulation differ in terms of the applicable legal requirements and in terms of their susceptibility to legal review. Thus, the more significant the legal changes brought about by the re-regulation in question, the more ‘demanding’ and susceptible to legal review should be the form and the source of that re-regulation.

Accordingly, the level of change brought about by the re-regulation in question, as well as its form and source, should condition the **substantive, jurisdictional** and **institutional** scope of the potential legal challenges that might arise. In other words, these qualities determine the types of legal requirements with which re-regulation must comply, as well as determining the question of under which legal framework (applicable rules and legal standards) and by which legal standard of review the legality of re-regulation should be assessed.

The following discussion first explores some of the substantive, jurisdictional and institutional legal issues that might arise in relation to various levels and forms of re-regulation and, second, discusses the susceptibility to legal challenge of the different re-regulation strategies outlined in Section 2.2 above.

- *Re-regulation: legal requirements*

As outlined above, the degree of change effected by measures of re-regulation, as well as their form and legal basis, will usually mean that the legal measure will be subject to different standards of legal review. Generally speaking, the following categories¹⁶ of legal review can be identified as relevant to the assessment of the

14 Regulations or directives, in case of regulatory frameworks established under the EU law, or national laws or statutes in case of regulations established under the national law of a certain country.

15 For example, “third order” regulatory changes should in general be effected by amendments to the primary legal instruments of a certain regulatory framework, whereas “first order” changes could be introduced by accordingly amending (or adopting new) implementing by-laws, or even soft-law instruments. Accordingly, if, for example, the regulatory framework subject to re-regulation is based on EU law and it is envisaged that third order changes be introduced, appropriate amendments to the primary EU law instruments would generally need to be introduced.

¹⁶ The categories are relative because, for example, recognised and relevant fundamental rights could also be characterised as either constitutional norms or to international law instruments, or even both. Similarly, some

legality of re-regulation initiatives:

- *constitutional norms;*
- *general principles of law;*
- *fundamental rights;*
- *relevant international treaties and conventions;*
- *other requirements derived from the hierarchical structure of legal systems (especially under an EU federalist model).*

Each of these categories is discussed in turn.

a) Constitutional norms

In the present context, constitutional norms are understood to refer to the rules (other than widely recognised fundamental rights, such as the right to property) that lie highest in the hierarchy of a particular legal order. These rules would arguably of most relevance to those re-regulation measures that bring about substantial changes to the existing regulatory regime, thereby necessitating amendments to the primary legislation under that regulatory system.

Relevant constitutional rules might differ depending on whether the regulatory framework in question is based on a supra-national or a purely national legal order. Accordingly, as regards regulatory frameworks based on, for example, EU law, such constitutional norms would be contained in the *Treaty on the European Union* (“TEU”) and in the *Treaty on the Functioning of the European Union* (“TFEU”). By contrast, as regards purely national regulatory frameworks, the national Constitution or an equivalent legal instrument would usually constitute a legal norm of such significance.

- ***EU legal instruments***

There are numerous rules and procedures that may be particularly relevant for the assessment of re-regulation measures. In particular, where re-regulation involves the amendment of primary law instruments, i.e., Directives and/or regulations, the re-regulation measures must comply with ‘constitutional’ EU rules applicable to law-making. This includes not only the need for the appropriate institutions to adopt the necessary measures in an institutionally legitimate way, but also the need for them to utilise the appropriate legal basis upon which to adopt the appropriate re-regulation measures.

might not accept that the TEU and TFEU are sources of constitutional norms.

- *Harmonization measures*

In this respect, Article 114 TFEU, which permits the EU to enact harmonization measures in areas where it does not have explicit competence to do so if such measures are “*necessary to establish or improve the functioning of the internal market*”, is of particular relevance.¹⁷ Accordingly, any re-regulation initiative that is premised upon Article 114 TFEU must ensure that the re-regulatory measures are indeed designed to remove genuine obstacles to the free movement of services or appreciable restrictions to competition.¹⁸ By implication, it will also be necessary to assess whether the disparities between national rules of the member states have a direct bearing on free movement or competition law principles,¹⁹ and if there is an appreciable risk of obstacles being erected to the realization of free movement goals or which are distortive of competition.²⁰ Applying these principles to re-regulation measures, these requirements would require that the existing regulatory system is essentially no longer efficient and/or that additional legitimate objectives are being pursued through the proposed re-regulation initiative.

In addition, a proper law-making process would have to entail the Commission performing a Regulatory Impact Assessment (“RIA”) exercise in order to justify its legislative initiatives. The proper performance of an RIA, including an adequate consultation with stakeholders, might have important implications for the ultimate legality of the resulting re-regulatory measure in question, including observance of the principles of “proportionality” and the protection of “legitimate expectations”.

The *Impact Assessment Guidelines*²¹ define an impact assessment as “*a process that prepares evidence for political decision-makers on the advantages and disadvantages of possible policy options by assessing their potential impacts.*” Such an assessment is comprised of information-gathering and consultations with stakeholders, which define both the problems being addressed and the policy objectives being pursued, while at the same time comparing the available policy options and determining the likely economic social and environmental impacts of the proposed measures.

- *Fundamental policy goals*

Moreover, Article 7 TFEU requires the EU to ensure consistency between its policies and activities, taking into account all of its objectives and in accordance with the

¹⁷ For example, the EU Electronic Communications Regulatory Framework and the 3rd Energy Package were adopted under Article 114 TFEU.

¹⁸ See A. Dashwood, D. Wyatt and others, *Wyatt and Dashwood’s European Union Law*, 6th ed. 2011, Hart Publishing, p. 107.

¹⁹ See, e.g., *C-380/03 Germany v Parliament and Council*, 12 December 2006, para. 54.

²⁰ *Ibid*, at paras. 68 and 85.

²¹ *Impact Assessment Guidelines* SEC(2009) 92, 15 January 2009.

principle of conferral of powers. Accordingly, any re-regulation initiative must not only take into account the possible implications on the immediate objectives of the regulatory framework in question, but also of other relevant EU policies and activities such as EU competition rules or environmental policy.

Thus, for example, in the context of the EU electronic communications regulatory framework, a radical change in the regulatory approach towards the prescription of access conditions to a certain bottleneck might have considerable implications on the competition policy of the EU. Similarly, the promotion of certain technical solutions or infrastructure in the energy or electronic communications sector might have a direct impact on energy efficiency objectives and EU environmental policy more generally. Fundamentally, the effect of Article 7 TFEU is probably that, despite its rather general terms, the legality of re-regulation activities which generate clear and considerable distortions between different policies goals and EU activities are considered to be compromised (even if indirectly), as a result of the obligation contained in Article 7 TFEU.

- *Non-contractual liability of the EU*

A possible implication of non-compliance by EU institutions with the relevant EU law requirements is the application of non-contractual liability to those EU institutions involved in the questionable measures of re-regulation. In particular, Article 340 TFEU states that, in the case of non-contractual liability, the EU shall, in accordance with the general principles common to the laws of the member states, make good any damage caused by its institutions or by its servants in the performance of their duties. Pursuant to the terms of Article 268 TFEU, the Court of Justice of the European Union (“CJEU”) shall have jurisdiction in such disputes relating to compensation for damage caused where it is concluded that non-contractual liability exists.

Accordingly, any firm subject to an *illegal* re-regulation measure promulgated by the EU institutions might bring an action for damages²² against the EU, provided that it can demonstrate the existence of a causal link exists between the substance of the illegal measures of re-regulation and/or the illegal procedures undertaken to promulgate such re-regulation measures, and the damages suffered as a result thereof.

- *The treatment of EU member state infringements*

The relevant rules of the TEU and the TFEU also play another role in the assessment of the legality of re-regulation activities. In particular, they establish a benchmark for

²² Including direct financial loss and, where appropriate, loss of profits.

the assessment of those measures against the principle of “effectiveness” in the implementation of EU measures into national law, on the one hand, while, on the other, containing various legal “safety measures” that place limits on the re-regulation activities generated by the Member States.

As regards the former, the European Commission can initiate infringement actions before the European Court of Justice against member states that do not (appropriately) transpose the relevant EU Directives. This is not at all a rare occurrence, as the Commission has brought numerous infringement proceedings in the implementation of different EU regulatory frameworks, especially in the context of national implementation measures affecting the electronic communications and energy sectors.²³

As regards the latter category, re-regulation measures emanating from member states of the EU are also subject to the constitutional rules of the TEU and TFEU. Accordingly, national re-regulation activities must not be contrary to the free movement rules, as well as to the principles enshrined in Article 106(1) TFEU, where the re-regulation measures involve the grant of special or exclusive rights to certain undertakings, or have consequences which are contrary to the so-called *effet utile* doctrine (e.g., where national law delegates market regulation activities to undertakings). Notably, these EU law rules are directly effective;²⁴ thus, the relevant stakeholders might challenge national regulatory measures before national courts by recourse to such directly effective EU law provisions.

- **National constitutional rules**

National constitutional rules usually contain similar rules to the EU on the appropriate institutional law-making that might need to be complied with in relation to certain re-regulation activities. In addition, other than more “substantive” constitutional rules relating to the organization of the economy or to exceptional state ownership rights, there might also exist other relevant legal obligations with respect to third order level re-regulation changes (e.g., the need for balanced budgets, the need for self-sustaining administrative charges for regulatory authorities, the need to respect existing contractual obligations, and so forth.).

b) General Principles of Law

Respect for the general principles of law is a particularly relevant category for the

²³ As regards electronic communications, refer to: ec.europa.eu/information_society/policy/ecom/implementation_enforcement/infringement/index_en.htm; as for energy, refer to: ec.europa.eu/energy/infringements/index_en.htm.

²⁴ Article 106(1) TFEU when applied in conjunction with another directly effective Treaty provision.

assessment of the legality of re-regulation measures, in that often many of these “general principles” of law are expressly established in the relevant set of national constitutional norms or form part of various international law instruments which expressly enshrine such fundamental rights. That being said, as regards those general principles of law which are particularly relevant for the discussion at hand, essentially the same set of principles governs both the EU and national legal orders (which means that no further distinction needs to be drawn between general principles of law set forth under EU and national legal orders).

The general principles of law perform various functions, especially as regards the establishment of limits on the legislative and administrative competence of various institutions, and with respect to the interpretation of specific legal provisions. A notable feature of applying general principles of law is that they may have an extensive reach and can be relevant to, for example, the assessment of legality and/or the interpretation of by-laws and even “soft law” instruments (and may thus also be or relevance to “first order” or “second order” re-regulation measures).

The following general principles of law are most likely to be of particular relevance for the assessment of the compatibility of re-regulation initiatives:

- ***Non-discrimination***

This principle requires that comparable situations not be treated differently, and for different situations not to be treated in the same manner, unless such treatment is objectively justified. This principle places very important legislative and administrative limits on re-regulation activities. In particular, instruments resulting from a re-regulation activity must not afford differential treatment without a proper justification for that differentiation.

The same holds true for the preparatory legislative and/or administrative stage, insofar as equal rights of participation in the shaping of the re-regulatory measures should be granted to all comparable stakeholders, as well as to the implementation stage of re-regulation measures. Thus, not only should the re-regulation measures not be discriminatory, but their actual implementation should also ensure the observance of the non-discrimination principle.

- ***Legal certainty and legitimate expectations***

The principle of legal certainty requires that those subject to the rules should be able to determine clearly the scope of their rights and obligations. In addition, the related concept of legitimate expectations is a corollary to the principle of legal certainty: those who act in good faith on the basis of the law as it is or it seems to be at the time of the acquisition of their rights should not be frustrated in their exploitation of

those rights in the future.

Of particular importance in the context of re-regulation is the fact that these principles require that administrative and legislative changes do not take effect without adequate notice of such changes being given to the stakeholders concerned. In other words, those undertakings to whom the measures apply must first be given an adequate opportunity to make themselves acquainted with its implications. Aside from exceptional and objectively justified circumstances, one of the hallmarks of these principles is that re-regulation measures must not have a retroactive application.

Accordingly, these principles lie at the very heart of the overarching need for regulation to be sufficiently stable and at the same time responsive to the changes affecting the subject-matter which is being regulated. The principles of legal certainty and legitimate expectations therefore impose various requirements on re-regulation activities which can in turn be further sub-divided into two categories, namely:

- (i) substantive requirements;
- (ii) procedural requirements.

As regards the former category, these principles essentially impose a quality standard on rule-making resulting based on re-regulation initiatives insofar as the rules must be sufficiently clear and precise in the establishment of legal rights and obligations. In relation to latter procedural requirements category, these principles address the questions of how re-regulation measures can be brought about and if it were reasonably possible to expect that certain regulatory changes would be introduced. Broadly speaking, new measures of re-regulation should be introduced with due notice to stakeholders, and upon proper discussion with such stakeholders, or at the very least those parties directly affected by the proposed measures. This principle might be considered to be enshrined in the various RIA and consultation procedures discussed above which, among other things, further the goals established by these principles.

It is these general principles of law that are most susceptible to being undermined even where an apparently minor element of the overall regulatory system is to be amended, at least where those measures are not compatible with these requirements and where the new amendments impose a considerable burden on those entities subject to the re-regulation measures (see discussion below).

- ***Proportionality***

Broadly speaking, the principle of proportionality requires that the measures

resulting from re-regulation do not go beyond what is necessary to pursue the stated objectives of the measures.²⁵ The failure of legislative or administrative acts to comply with the principle of proportionality might mean that they are subject to annulment. Thus, the principle of proportionality must be observed both when certain re-regulation measures are being adopted and when they are subsequently applied.

In addition to having a very broad field of application, the principle of proportionality is also among one of the requirements that need to be satisfied whenever the effect of re-regulation measures is to limit the scope of fundamental rights, including those cases where a nuanced approach is taken towards the application of the principle of non-discrimination.

c) Fundamental rights

Although the concept of fundamental rights encompasses a wide range of rights that are characteristic to a civilised and democratic society, for the present purposes two of those rights are of particular interest when contemplating legal challenges to re-regulation measures, namely:

- (i) the right to property;
- (ii) the right to effective judicial protection.

Both of these rights are enshrined in the *EU Charter of Fundamental Rights* and in the *European Human Rights Convention*, as well as in most, if not all, of the national constitutions of the EU member states. Each of these rights is considered immediately below.

▪ The right to property

The fundamental right to property means that everyone has the right to own, use, dispose of and bequeath his or her lawfully acquired possessions in accordance with national law provisions. No one may be deprived of his or her possessions, except in the public interest and in those cases and conditions specified by law, subject to fair compensation being paid in good time for their loss. The use of property may be regulated by law in so far as is necessary for the general interest.²⁶

Community law provides that nothing in the Treaty shall affect the right to property. Nevertheless, it is a long established community law principle that the *existence* of a right to property under national law is not adversely affected if community law

²⁵ See, for example, Article 5 TEU.

²⁶ See *EU Charter of Fundamental Rights*, Article 17.

simply restricts the *exercise* of that property right. The right to property is thus of considerable importance as regards various unbundling arrangements in the respective electronic communications and energy sectors that might be introduced or refined as part of a certain re-regulation initiative.²⁷

Given the existence of different forms of unbundling arrangements, namely, functional/operational unbundling, legal unbundling, ownership unbundling and various combinations thereof, one of the major issues that arise in this context is the observance of the “proportionality” requirement when determining whether a restriction on the exercise of a property right is legitimate. In particular, one may question whether ownership unbundling is really necessary to achieve certain, usually competition-driven objectives. While there is little discussion as to whether ownership unbundling is a suitable and effective remedy, its necessity relative to other forms of unbundling or a set of other regulatory remedies (e.g., a combination of non-discrimination and transparency measures) is a far from settled issue. Similar considerations might equally apply to “lighter” forms of unbundling when compared to “lighter” forms of alternative regulatory intervention.

Accordingly, any re-regulation strategy encompassing unbundling arrangements needs to be carefully structured and introduced with appropriate levels of consultation for stakeholders, as it may be particularly susceptible to legal challenges by stakeholders, not least also because of the significant property interests affected.

- ***The right to effective judicial protection***

The right to effective judicial protection, which can also be framed as the right to an effective remedy and to a fair trial,²⁸ means that everyone whose rights and freedoms guaranteed by the law are violated has the right to an effective remedy before a proper tribunal.

The right to effective judicial protection might be a particularly delicate issue in those cases of re-regulation where the changes occur at the level of by-laws or even “soft law” instruments, as is often the case in the electronic communications sector which is characterised by the need for regulation to keep pace with technological developments. More specifically, the most significant legal pitfall in such cases may be brought about by attempts to establish *de facto* a compulsory regulatory solution through measures that are not subject to an effective appeal mechanism because of their “soft law” nature. Accordingly, any re-regulation strategy should ensure that

²⁷ Regulatory unbundling mandates can be found in, for example, the EU Electronic Communications Regulatory Framework and particularly in the 3rd EU Energy Package.

²⁸ See *EU Charter of Fundamental Rights*, Article 47.

the resulting measures and further decisions implementing them are actually subject to an effective level of judicial control allowing stakeholders to appropriately defend their rights.

Further complications arise in the interplay between community law and national legal orders, to the extent that it is felt that national procedures do not support the “effective application” of community law. Interestingly, it might often be the case that a national institution is subject to a legal standard of review that is much more onerous than the legal standard to which the European Commission is often subject. This is the case under the EU regulatory framework for electronic communications networks and services, where national regulatory authorities are subject to a judicial review of their decisions “on the merits”, whereas the Commission’s decisions are subject to a review by the European courts under the less onerous administrative law standard of “manifest error”.

d) International treaty obligations

It is also the case that, where re-regulation measures are adopted, their legality needs to be vetted against legal obligations undertaken by the European Commission or by sovereign states in question under international treaty instruments such as multilateral treaty obligations such as the WTO. Electronic communications, for example, are subject to international treaty obligations in a number of important respects. However, the issue arises as to whether those treaty obligations are directly enforceable in member state courts, and the answer turns in each case on the manner in which the constitutional principles of a state directly implement treaty obligations or require their separate adoption into the national legal order (much in the manner in which Directives are adopted domestically into national law by EU member states).

In the case of many sovereign states, reference also needs to be made to bilateral investment agreements entered into by sovereign states on behalf of undertakings of their nationality in order to secure the value of their investments made by their “nationals”. Seen in this light, re-regulation measures which affect the property valuations of investments made by “foreign” firms might be subject to this additional degree of scrutiny under international law.

e) Other implications derived from the hierarchical nature of legal systems

The final category of legal requirements that can be relevant for re-regulation measures can be inferred from the hierarchical organisation of legal systems. The general requirement stemming from such a hierarchical organisation is that

regulatory rules established by instruments that are lower in the legal hierarchy should not be contrary to, or not too extensive in relation to, the relevant rules that can be found in the upper echelons of the legal hierarchy. Therefore, a re-regulation strategy that takes place in the form of changes to by-laws or other instruments subordinate to regulatory instruments of higher legal force must ensure that such changes are in compliance with the rules to which the amended or newly introduced rules are subordinate.

Particularly delicate issues can arise in those cases where soft law instruments contain statements and “rules” which are contrary to, or at least undermine in part, relevant legal rules that are more highly placed in the legal hierarchy. This impact might be further reinforced where the overall strategy is to introduce indirectly a *de facto* binding solution through the use of soft law instruments. The key legal question is whether such soft law anomalies can be controlled effectively under the process of judicial review. As regards EU law, the case-law in the field of electronic communications suggests that a reference for a preliminary ruling to the Court of Justice may also relate to non-binding EU legal acts; thus, the national court or tribunal concerned by a legal review of a re-regulation measure could, by means of such a reference, determine *inter alia* whether the non-binding EU act is based on a correct interpretation of EU law.²⁹

f) Application of principles to specific re-regulation policies

Generally speaking, re-regulation initiatives can have two dimensions: substantive and procedural. The substantive dimension primarily refers to the material impacts on the market behaviour of operators which might result from re-regulation measures. Those regulatory measures need to comply with the various relevant legal policy requirements discussed above. The procedural dimension of re-regulation relates to the kinds of legal techniques that can be used to manage such changes or adjustments to existing regulation (in other words, the variety of different *procedures* related to the issue of *how* re-regulation measures can be effected).

Thus, it is not only the substance of legal instruments resulting from a re-regulation initiative that must comply with the relevant legal requirements, but also the procedure, i.e., the re-regulation policy that is employed to achieve the sorts of regulatory changes that must satisfy the relevant legal standards.

Table 4 below discusses each of the specific re-regulation strategies discussed earlier in Section 2.2 in terms of their susceptibility to legal challenge in accordance with the

²⁹ See Case T-109/06 *Vodafone España, SA and Vodafone Group plc v Commission of the European Communities* [2007] ECR II-05151, para. 102.

principles outlined above.

Table 4: Susceptibility to legal challenge of re-regulation strategies

Re-regulation policy	Security from legal challenge
<p>Term assurance</p>	<p>This policy typically involves sector-specific regulators undertaking not to change the substance of a key regulatory obligations (e.g., usually in the form of primary legislation or a particular regime of regulatory intervention) within a specified timeframe. Such a strategy is essentially designed to afford a certain degree of legal certainty to stakeholders.</p> <p>Provided that the substantive measures resulting from the re-regulation measures following the expiry of term assurance comply with the relevant legal requirements, the institutional and procedural requirements on rule-making are observed,³⁰ the duration established under the term assurance is satisfied,³¹ and assuming that the principle of non-discrimination is satisfied, the re-regulation policy should generally be secure from legal challenge.</p> <p>In addition, once the timing is appropriate for re-regulation, the actual consideration and crafting of the new regulatory measures might entail the performance of a proper RIA, including necessary public consultations, in order to satisfy the procedural requirements of a lawful rule-making process, especially the principles of legal certainty and legitimate expectations. Accordingly, in order to increase the degree of security from legal challenge, the actual re-regulation measures which follow upon expiry of the specified term subject to term assurance must also take into account these requirements.</p>
<p>Notice and information</p>	<p>Under this policy, sector-specific regulators undertake to provide notice to firms when regulatory changes are being contemplated so that they can re-orientate their market behaviour. However, this policy does not go beyond the mere giving of notice, falling short of operators being invited to participate in the actual re-regulation process.</p> <p>This policy is thus designed to ensure a degree of legal certainty. However, the principles of legal certainty and legitimate expectations might be undermined if regulatory changes were introduced which provided little more than due notice to stakeholders.</p> <p>Accordingly, the need to otherwise conduct a full consultation with those that will be affected by the re-regulation measures, thereby reflecting the principles of legal certainty and legitimate expectations,³² might be difficult to reconcile with a simple re-regulation policy of notice and information.</p> <p>By contrast, insofar as the policy is effected through carrying out of a comprehensive public consultation process, the re-regulation measures should in principle be secure from legal challenge (provided that essentially the same set of requirements set out with respect to term assurance are satisfied).</p>

³⁰ *i.e.*, that the appropriate institutions adopt the new regulatory measures on the basis of an appropriate legal base for such action.

³¹ Otherwise, non-compliance with the terms of Term Assurance would strike against the principles of legal certainty and legitimate expectations of stakeholders.

³² In those jurisdictions where this requirement forms part of the scope of the principles of legal certainty and legitimate expectations.

Re-regulation policy	Security from legal challenge
<p>Negotiations and compliance discussions</p>	<p>Pursuant to this policy, sectoral regulators go beyond the mere giving of notice and hold out the opportunity of suggesting ways in which changes can be effected so as to reduce adjustment costs or to increase consumer benefits. Regulators may also assist operators to plan for prospective change so as to reduce their adjustment costs.</p> <p>When compared to the notice and information policy (see above), this strategy should be more secure from legal challenge with respect to those jurisdictions where the principles of legal certainty and legitimate expectations require the performance of a full and proper consultation with those affected by the re-regulation measures.</p> <p>Accordingly, provided that the set of requirements outlined above in relation to term assurance are satisfied, this re-regulation strategy should be generally considered to be secure from legal challenge. However, the principle of non-discrimination might be a particularly complex issue to address where the specific re-regulation strategy involves the regulator’s assistance to regulated operators. Those firms which feel that, compared to other operators, they receive less assistance from the sectoral regulator, might be inclined to challenge this re-regulation measures by recourse to the non-discrimination principle. The difficulty of establishing appropriate comparative benchmarks (to determine any presence of discrimination) might be a particularly complex issue, thus potentially encouraging the disgruntled firms to litigate.</p>
<p>Transition programmes, timescales and reviews</p>	<p>Closely related to the issues considered in connection with the negotiations and compliance discussions policy discussed above, sectoral regulators implement policy changes incrementally and indicate the periodic timescales within which compliance has to be achieved. They may also undertake to review regulatory approaches periodically so as to reduce the compliance costs of over-inclusive regulation.</p> <p>If anything, this policy should be at least equally as secure from legal challenge as the preceding policy. By the same token, depending on the precise form which the re-regulation policy might take, it might be as equally susceptible to legal challenge on the grounds of discrimination, as noted in relation to the preceding policy.</p>
<p>Parallel concessions and compensation</p>	<p>Under this policy, sectoral regulators might attempt to reduce the more undesirable impacts generated by a re-regulation policy which seeks to balance the proposed policy changes against the granting of concessions to regulated operators.</p> <p>This policy might therefore have both a procedural dimension, as regards its mode of implementation, and a substantive dimension, as regards the material scope of the concessions granted.</p> <p>As regards the procedural dimension, the same set of requirements concerning institutional and procedural requirements regarding lawful rule-making, the principles of legal certainty and legitimate expectations, as well as the principle of non-discrimination, also need to be respected with respect to this policy.</p> <p>As regards the substantive dimension, depending on the precise scope and form of concessions granted, legal challenges might arise on the basis of Article 106 TFEU, EU state aid rules or free movement rules,³³ as well as on the basis of relevant international trade agreements or the non-observance of the general principle of non-discrimination. Generally speaking, in order for the concessions granted to be</p>

³³ Or, as regards national regimes, on the basis of comparable national laws.

Re-regulation policy	Security from legal challenge
	secure from legal challenge, they must not discriminate against any firm, including (in the EU context) those of other member states, they must not be capable of producing significant anti-competitive effects and they must be in compliance with any other imperative requirements of the relevant legal order.
Flexibilities	Under this policy, sectoral regulators might be willing to provide regulated operators with a certain degree of flexibility in terms of compliance and provide them with some freedom of scope regarding the means chosen to deliver desired policy outcomes. Essentially the same legal considerations apply as applied to the parallel concessions and compensation policy considerations.
Advice, guidance and assurance	Under this policy, the sectoral regulators might seek to relax the transitional difficulties between different regulatory regimes by delivering (or assuring regulated operators that they will issue) advice or guidelines on new compliance requirements. A focal point of this strategy is to limit the degree of regulatory risk involved, by ensuring that a high standard of behaviour is implemented which the regulator will deem to be compliant. If applied as a stand-alone strategy, i.e., not in combination with, for example, the notice and information policy or a comparable policy, ³⁴ the policy regarding advice, guidance and assurance might be susceptible to legal challenges based on the principles of legal certainty and legitimate expectations. In addition, this regulatory policy might also have a substantive dimension, insofar as any explanatory guidelines issued by the sectoral regulator would need to comply with the various requirements arising from the hierarchical organisation of legal systems (and might thus be susceptible to legal challenge by stakeholders on various grounds).

³⁴ Which, by implication, would mean that re-regulation takes place prior to or simultaneously with the issuance of relevant guidelines or advice.

3. Regulatory stability: the impact of European legislation

The prime source of regulatory change or 'instability' in the European Union in the last twenty years has unquestionably been European-level legislation. It is, accordingly, necessary to consider the special challenges that arise from this source.

What cannot be doubted is that the most fundamental changes in regulation often flow from new laws that determine the institutional structure of regulation, the powers and accountability of the regulator, its objectives or duties, and the powers or instruments at its disposal to achieve its goals. Such laws may also determine the sources of the regulator's income and the opportunities for firms affected by its decisions to appeal its decisions – both of which are of fundamental importance in determining regulatory effectiveness.

The European institutions have deployed their law-making powers to effect radical changes in many regulated sectors. The continued growth in importance of single market issues and the intractability of the problem of reforming national markets dominated by historic monopolists have created a gap into which the Commission in particular has inserted itself.

A series of sector-targeted reforms have involved successive waves or packages of legislation which have been directed at a combination of liberalisation and harmonisation. The telecommunications sector was the first to experience this process, with a series of developments over an extended period beginning with the publication of a green paper in 1986 and culminating with measures anticipating, accompanying or shortly following the opening up of markets to competition in 1998. This set of rather crude measures then gave way in 2003 to a systematic and well-thought out set of Directives known as the "New Regulatory Framework". These were transposed with some delay, but by about 2005 the sharing of powers between the Commission and the NRAs envisaged in the Directives had taken hold. Then in 2009 relatively small revisions were legislated.

In three other sectors, energy, rail and post, the sequential nature of the twin processes of liberalisation and harmonisation was emphasised by the explicit designation of the measures as numbered Directives or packages; postal regulation starting with the first Directive of 1997, with the third Directive coming in 2008; energy starting in 1996 and having now notched up its third package; rail starting a little later and about to receive its fourth package. Only water has escaped this process, but this has been compensated for by particularly severe environmental regulation.

The Directive, however, is not the only mechanism that the European Commission

can use to achieve changes in the structure of regulation. Competition law has also been deployed for the same purpose. This has been most visible in the field of energy regulation, where the Commission's [energy] inquiry and a number of Article 102 investigations have offered additional levers to accomplish behavioural and structural objectives reflecting regulatory policy initiatives. The combination of new Directives and enforceable undertakings offered in competition cases can be a powerful instrument for change. On one hand, the outcomes of competition law cases can confirm the direction of travel of policy and regulation and have a confirmatory or even stabilising effect. On the other, if such outcomes precede or go beyond what is in the Directives, and if a settlement decision not subject to legal challenge becomes a de facto standard, the result may be greater instability. These issues are discussed further in Appendix 2.

The sequences of legislative changes that have been effected in the telecommunications, energy and rail sectors have been extensive and their elements can be set out as follows. The relevant phases of the respective programmes are followed by lists of the main regulatory issues dealt with.

3.1. Telecommunications

Phase 1: the 1998 measures

- *obligations to interconnect;*
- *price control for those with significant market power (SMP);*
- *local loop unbundling;*
- *retail price controls;*
- *carrier selection and pre-select.*

Phase 2: the 2002 Directives (implementation 2003)

- *a uniform approach to all markets;*
- *identification of markets subject to ex ante regulation;*
- *market definition (based on anti-trust principles) and designation of SMP (a requirement for intervention);*
- *application of remedies, such as cost-oriented access prices.*

Phase 2bis: the 2009 revisions (implementation 2010?)

- *enhanced consumer protection, based on 'net neutrality' concerns;*
- *inclusion of functional separation as a remedy.*

3. 2. Energy

First Package 1996 and 1998

- *these two Directives, covering electricity and gas respectively, tried to open markets and to create an internal market. They met with limited success and were replaced in 2003.*

Second Package 2003

- *imposed universal service and consumer protection obligation;*
- *new capacity must be tendered;*
- *obligations on transmission and distribution system operators to secure supply and ensure non-discrimination among system users;*
- *independence of transmission and distribution operators;*
- *separate accounting by electricity undertakings.*

Third Package 2009

- *separation/unbundling of transmission system operators(TSOs);*
- *formalisation of co-operation among them;*
- *network codes and framework guidelines to be developed;*
- *creation of Agency for cooperation of Energy Regulators (ACER).*

3. 3. Railways

First package 2001 (implementation 2003)

- *promotes market opening, improved freight performance and integrated transport planning;*
- *opens international freight market;*
- *separates management of infrastructure from operation of rail services;*
- *introduces separate accounting;*
- *co-operation among infrastructure required;*
- *(the First Package was 'recast' or strengthened 2011).*

Second Package (adopted 2004)

- *aims to create a legally and technically integrated European railway area;*
- *opens up the rail freight market (national and international) to competition*

from 2007 widens access rights to international passenger services;

- *harmonises and clarifies interoperability requirements for both high speed and conventional rail systems;*
- *European Railway Agency created.*

The Third Railway Package 2007

- *opens up international passenger markets to competition from 2010, including for the purposes of cabotage;*
- *providers of such services must be granted access to the infrastructure;*
- *introduces an 'international driver's licence' was introduced for train crew;*
- *passengers' rights strengthened;*
- *a further Directive on interoperability agreed.*

3. 4. Postal services

First Directive 1997

- *defined and standardised the Universal Service Obligation (USO) and the Universal Service Provider (USP);*
- *created a reserved area of letters under 350 grams;*
- *proposed independent regulation for postal services.*

Second Directive 2002

- *reduced the reserved area to below 20 grams;*
- *created an access regime;*
- *provided for competitors to contribute to the cost of the USO.*

Third Directive 2008

- *liberalised the whole market from 2011, with some derogations.*

3. 5. How much regulatory instability is involved?

Three aspects of stability were highlighted in the introduction above: controls, timescales and tractability. If reference is made to these, it can be said that, in the narrow sense, EU legislation has not been stable. *Controls* have not been immutable, but have shifted significantly. Changes have taken place at first, second and third-order levels. EU legislation has fundamentally changed the regulatory regimes in the

telecommunications, energy and rail sectors.

When *timescales and tractability* are taken into account, however, the EU legislative programmes can be seen to be relatively stable in the broader sense of the term. The above programmes have generally been gradualist in nature and changes have moved regulation in directions which could reasonably be predicted, at least in outline terms. The procedure adopted - a tripartite process of law-making - has, after all, not only involved gradualist and predictable changes, it has allowed affected parties many opportunities to intervene. The text of a draft Directive (if subject to the co-decision process, as contentious matters usually are) is prepared by the Commission after consultation with its own and national experts. The draft is presented to the Parliament and the Council initially for evaluation and comment, then subsequently for approval or rejection. Only when Parliament and the Council are in agreement can the text be passed into law.

Typically, a Directive is trailed by the Commission, and national and other experts are involved in its preparation. Different parts of the Commission may have different views over what it should contain. It then goes through scrutiny and revision by the Parliament. Simultaneously with this process, and after its completion, the Council is involved in the discussion. Affected parties thus have opportunities to lobby the Commission, Parliamentary representatives, and the governments of member states. The process as a whole may take several years. Transposition into national law is then required, (although the Directive comes into effect immediately). Since a Directive leaves some discretion to the national authorities as to the form and method of the achievement of its goals, an element of discretion is introduced both into transposition and enforcement of the law.

With reference to the re-regulation strategies referred to in section 2.2 above, it can be seen that the European legislative process incorporates a large element of notice and information. To a lesser degree, negotiations and compliance discussions may be involved but these are not likely to involve individual firms as opposed to associations or government representatives. Little use is made of term assurance strategies, transition programmes, parallel concessions or other re-regulation strategies. It should be remembered, however, that when national authorities take actions to implement European Directives, they are free to employ a variety of re-regulation strategies at the domestic level: they may not be able to guarantee the term of the Directive but they may well be able to engage in advice, guidance and assurance, negotiations and compliance discussions, transition programmes, flexibilities, parallel concessions and other re-regulation approaches that are designed to limit adjustment costs and foster tractability.

4. Three Case Studies on Re-regulation

4.1. European telecommunications: potential changes to the regulatory regime

4.1.1. Introduction

A particularly complex assessment of the elements of regulatory certainty can be evidenced in the legal system of checks and balances which characterise regulatory decision-making under the EU Electronic Communications Regulatory Framework (“Framework”). That Framework seeks to balance the goal of subsidiarity, on the one hand, by devolving key decision-making powers to National Regulatory Authorities (“NRAs”), while at the same time seeking to achieve the community goal of harmonisation. However, it is the additional goal of effective judicial review which is most compromised in a regime which also needs to be flexible in order to be able to address technological innovation and change. The net result is that legal certainty for operators – measured by the ability of affected stakeholders to seek judicial review of decisions which they consider to be unfounded – is compromised.

The Framework³⁵ was established in 2002 in order to achieve a harmonised system of regulation for electronic communications networks and services,³⁶ with the ultimate purpose of creating the conditions for effective competition during the transitional period from national monopolies to fully competitive internal market.³⁷ The operation of the Framework is based on the fundamental principle that the

³⁵ The Framework is composed of the following acts: Directive 2002/21/EC of the European Parliament and of the Council of 7 March 2002 on a common regulatory framework for electronic communications networks and services (“Framework Directive”), OJ L 108, 24.4.2002, p. 33–50; Directive 2002/19/EC of the European Parliament and of the Council of 7 March 2002 on access to, and interconnection of, electronic communications networks and associated facilities (“Access Directive”), OJ L 108, 24.4.2002, p. 7–20; Directive 2002/22/EC of the European Parliament and of the Council of 7 March 2002 on universal service and users' rights relating to electronic communications networks and services (“Universal Service Directive”), OJ L 108, 24.4.2002, p. 51–77; Directive 2002/20/EC of the European Parliament and of the Council of 7 March 2002 on the authorisation of electronic communications networks and services (“Authorisation Directive”), OJ L 108, 24.4.2002, p. 21–32; Directive 2002/58/EC of the European Parliament and of the Council of 12 July 2002 concerning the processing of personal data and the protection of privacy in the electronic communications sector (“Directive on Privacy and Electronic Communications”), OJ L 201, 31.7.2002, p. 37–47.

In 2009 the Framework Directive, the Access Directive and the Authorization Directive were amended by Directive 2009/140/EC – Better Regulation Directive, OJ L 337, 18.12.2009, p. 37–69; the Universal Service Directive and the Directive on Privacy and Electronic Communications were amended by Directive 2009/136/EC – Citizens' Rights Directive, OJ L 337, 18.12.2009, p. 11–36. In addition, in 2009 Regulation (EC) No 1211/2009 of the European Parliament and of the Council of 25 November 2009 establishing the Body of European Regulators for Electronic Communications (BEREC) and the Office (“BEREC Regulation”), OJ L 337, 18.12.2009, p. 1–10, was adopted.

³⁶ See Recital 41 to the *Framework Directive*.

³⁷ See Recital 1 of the *Framework Directive*.

actual regulation of specific relevant markets is to be carried out exclusively by specialist independent NRAs. That is so because NRAs are best placed to impose, in accordance with the principles and rules established by the regulatory framework, *ex ante* regulatory measures,³⁸ as most electronic communications markets that might require regulation are national or even sub-national³⁹ in their geographic scope and important differences in market conditions exist across different member states of the EU.⁴⁰

- *Jurisdictional competences under the EU regulatory framework*

The manner in which the Framework is structured from an institutional perspective is particularly challenging, given that it seeks to balance a variety of institutional actors whose interests are fundamentally in conflict. Achieving the appropriate institutional balance in such circumstances is especially difficult, especially insofar as effective decision-making (however measured) might be considered to have a material adverse impact on the effective assertion by private stakeholders of their legal rights, which in turn affects very significantly their perception of the “certainty” which imbues the Framework. Accordingly, it is appropriate that the different elements of that institutional matrix established under the Framework be considered in some detail.

- *Creation of specialised independent NRAs*

As a preliminary matter, the Framework requires member states to designate/create specialised independent⁴¹ NRAs which shall be competent to carry out the task of regulating the relevant electronic communications markets. This reflects the fundamental principle that the actual *ex ante* regulatory measures should be imposed by specific national authorities which are best placed to perform such a function. In the words of the General Court, the regulatory framework “assign[s] a central role to NRAs”.⁴² This exclusive mandate for NRAs is also in accordance with

³⁸ In order to achieve the aims of the Regulatory Framework, it provides for a possibility of both asymmetric regulation, that is to say regulation that is imposed on undertakings having significant market power (‘SMP’) in the relevant market, and symmetric regulation which can be imposed on all undertakings in the relevant market, irrespective of the degree of market power that each of them possesses. For the purposes of following discussion, it is the SMP-based regulation that is mostly relevant. Accordingly, unless the context requires otherwise, symmetric regulation is not discussed hereafter.

³⁹ See Recital 7 to the *Better Regulation Directive*.

⁴⁰ See, for example, Recital 3 to the Commission Recommendation of 17 December 2007 on relevant product and service markets within the electronic communications sector susceptible to *ex ante* regulation in accordance with Directive 2002/21/EC of the European Parliament and of the Council on a common regulatory framework for electronic communications networks and services), OJ [2007] L 344, p. 65–69. See also Explanatory Note (Second Edition) of the Commission accompanying the RM Recommendation (SEC (2007) 1483/2), at Section 2.3.

⁴¹ See Article 3(1) and 3(2) of the *Framework Directive*.

⁴² See Case T-109/06 *Vodafone España, SA and Vodafone Group plc v Commission of the European Communities* (‘*Vodafone España*’) [2007] ECR II-05151, para. 72. Similarly, at para. 73, the General Court establishes that the

the EU law principle of subsidiarity, which presupposes that in the fields of shared competence action should be taken on the level which is more effective for the achievement of the envisaged objectives.⁴³

- *Commission's advisory role*

Pursuant to the Framework,⁴⁴ the Commission has an important role to play in preparing the ground for *ex ante* regulation by NRAs of the relevant electronic communications markets. More specifically, the Commission has to adopt a "*Recommendation on relevant product and service markets*".⁴⁵ This *relevant markets Recommendation*, which is subject to regular revision by the Commission, is designed to identify those product and service markets which justify the imposition of regulatory obligations set out in the *specific Directives*.⁴⁶ In addition, the Commission publishes guidelines for market analysis and the assessment of significant market power ("*SMP Guidelines*").^{47 48} Under the Framework, a finding of SMP on a relevant market is a prerequisite for imposition of asymmetric *ex ante* regulation. By adopting the *RM Recommendation* and the *SMP Guidelines* the Commission is supposed to provide *assistance* to NRAs in performing the regulatory tasks.⁴⁹

In the original Framework⁵⁰ instruments adopted in 2002, Article 19 of the *framework Directive* provides for the possibility that the Commission can issue Recommendations to member states on the harmonised application of the Framework. Where a Recommendation is issued, it is for member states to ensure that NRAs take the 'utmost account' of it in carrying out their tasks.⁵¹ However, as a matter of law, Recommendations are of non-binding nature,⁵² which means that NRAs are in principle free to depart from them, provided that sufficient reasons are cited for such a departure. Most notably, on 7 May 2009, the Commission adopted

structure of the *Framework Directive* also reflects the central role of NRAs.

⁴³ See Recital 41 to the *Framework Directive*.

⁴⁴ See Article 15(1) of the *Framework Directive*.

⁴⁵ The *RM Recommendation* referred to in footnote 6 above is the currently applicable recommendation adopted pursuant to Article 15(1) of the *Framework Directive*.

⁴⁶ See Article 15(1) of the *Framework Directive*.

⁴⁷ See Commission Guidelines on market analysis and the assessment of significant market power under the Community regulatory framework for electronic communications networks and services, OJ [2002] C 165, p. 6–31.

⁴⁸ See Article 15(2) of the *Framework Directive*.

⁴⁹ See *Vodafone España*, at para. 75.

⁵⁰ That is to say, prior to 2009 amendments. Article 19 was substantially amended in 2009, as is discussed further in Part 2.

⁵¹ See Article 19(2) of the *Framework Directive*.

⁵² See case C-55/06 *Arcor AG & Co. KG v Bundesrepublik Deutschland* [2008] ECR I-2931, at para. 94. See also Article 288 of the *Treaty on the Functioning of the European Union* ('TFEU') (Consolidated version), OJ [2010] 83/53.

its *Recommendation on the regulatory treatment of fixed and mobile termination rates in the EU*⁵³ (the “*Termination Rates Recommendation*”).

- *Procedure to be followed by NRAs*

NRAs are obliged to take “the utmost account” of the *relevant markets Recommendation* and the *SMP Guidelines* when defining relevant markets appropriate to national circumstances.⁵⁴ Having defined the relevant markets, NRAs are obliged to carry out an analysis of each identified relevant market taking the utmost account of the *SMP Guidelines* in order to determine if the market is effectively competitive, i.e., if there is individual or collective SMP in that relevant market. Where an NRA determines that particular undertakings individually or jointly hold SMP on a relevant market, it must impose on such undertakings appropriate specific regulatory obligations or amend such obligations where they are already in existence. In performing this exercise, an NRA’s findings are initially subject to a national consultation and transparency mechanism⁵⁵ and, subsequently, to Commission review under the procedure set forth in Article 7 of the *framework Directive*.

- *Article 7 proceedings: case-specific involvement of the Commission*

From its introduction in 2002, the Framework contained a specific procedure under Article 7 of the *framework Directive* which seeks to balance the independent decision-making powers of NRAs with the overriding aims of the Framework, also affording “more direct involvement”⁵⁶ by the Commission in the goal of harmonising the delicate decision-making process required of NRAs under the Framework. More precisely, Article 7 of the *framework Directive* provides for the use of an EU consultation and cooperation procedure⁵⁷ which affords the Commission, BEREC⁵⁸ and NRAs the right to comment on the regulatory measures to be adopted by a particular NRA, where those measures would affect trade between member states. The NRA in question has to take the “utmost account” of any comments received under this consultation procedure before it adopts a final regulatory measure.

Given the nature of the consultation, NRAs are not bound by its results as a matter of law, provided that the NRA provides sufficient reasons for any departure from what has been recommended. The only duty arising from notification of an

⁵³ See Recommendation 2009/396/EC, OJ [2009] L 124/67.

⁵⁴ See Article 15(3) of the *Framework Directive*.

⁵⁵ See Article 6 of, and Recital 15 to, the *Framework Directive*. See also Recital 17 to *Better Regulation Directive*.

⁵⁶ See *Vodafone España*, at para. 77.

⁵⁷ See *Vodafone España*, at para. 89.

⁵⁸ BEREC since 2009.

envisaged regulatory measure is “to examine the notified draft measure in order to ensure that decisions at national level do not have an adverse effect on the single market or other Treaty objectives”.⁵⁹ Moreover, the right to make comments has a specific purpose of providing insight into the notified measure’s impact on the (achievement of) internal market/the objectives of the Framework. Accordingly, the right to comment under Article 7(3) of the *framework Directive* should not go beyond this very specific purpose. The misuse of this right to comment would create incentives for stakeholders in the particular member state involved to engage in costly and often opportunistic litigation against the relevant NRA, with all the negative consequences that would arise therefrom.

Beyond its consultation procedure, however, the Commission is granted a **veto power**⁶⁰ over certain NRA decisions, namely, those decisions:

- *that define a relevant market which differs from those defined in the relevant markets Recommendation;*
- *that designate that an operator or operators hold individual or collective SMP in that relevant market.*

This veto power is predicated upon the understanding that the proposed decisions by the NRA in question will affect trade between member states and thus create a barrier to the single market, or raise serious doubts for the Commission as to their compatibility with EU law, particularly those objectives referred to in Article 8 of the *framework Directive*.⁶¹ The veto power does not mean that NRAs are deprived of the exclusive competence to impose actual regulatory measures, but it does mean that, under certain clearly defined conditions, the Commission has the right to preclude the NRA from adopting a decision which would run counter to the objectives of the Framework.

Most importantly, consistent with the fundamental principles of EU law, in particular the principle of effective judicial protection,⁶² it is only decisions of the Commission exercising this veto power which are appealable before the Court of Justice of the European Union (CJEU).⁶³ The vast bulk of the Commission’s advisory powers are not, however, subject to such an appeal procedure.

⁵⁹ See *Vodafone España*, at para. 78.

⁶⁰ In the words of the General Court. See *Vodafone España*, at para. 83.

⁶¹ See Article 7(4) and 7(5) of the *Framework Directive*.

⁶² See case C-426/05 *Tele2 Telecommunication GmbH v Telekom-Control-Kommission* [2008] ECR I-00685, at para. 30.

⁶³ See *Vodafone España*, at para. 103. See also Article 263 of the *Treaty on the Functioning of the European Union* (‘TFEU’) (Consolidated version), OJ [2010] 83/53.

- *Judicial control of NRAs' regulatory activities*

As noted above, NRAs are the only competent authorities capable of imposing *ex ante* regulation in relation to the relevant electronic communications markets.⁶⁴ However, this exclusive competence of the NRAs is not absolute, as Article 4 of the *framework Directive* also requires national law to establish the right of appeal against NRA decisions to competent national courts of the member states, in accordance with the principle of effective judicial protection⁶⁵ and the principle of subsidiarity.

Accordingly, a final NRA decision can only be suspended or overturned by a competent national court.⁶⁶ Such a framework for legal review is also fully consistent with the principle of supremacy and effectiveness of EU law, as any questions that may arise in relation to EU law can be⁶⁷ referred to the Court of Justice, which is the ultimate authority for interpreting EU law.⁶⁸ Moreover, the Framework requires that national courts be competent to hear such appeals, which ensures that *effective* judicial control is being exercised over the application of the Framework.

The procedure outlined above should be contrasted with the EU's consultation procedure and with the Commission's powers under Article 7(3) and its Recommendations issued under Article 19 of the *framework Directive*. Under Article 7(3), the Commission's involvement is limited to an *advisory* role and only to the stage of a final regulatory measure being adopted by an NRA. The Commission has the right to comment on the envisaged draft measures, but the ultimate decision is to be taken solely by the NRA in question, having taken the utmost account of all comments received,⁶⁹ with the same applying to Recommendations issued under Article 19 of the *framework Directive*. Given the merely advisory nature of the Commission's Article 7(3) comments and Recommendations under Article 19⁷⁰ which render them non-appealable before the European courts,⁷¹ any implications of departure from the comments on the envisaged regulatory measure⁷² can and should only be tested *before the competent national courts*. More specifically, the

⁶⁴ This also holds for transnational markets, in which case the relevant NRAs have to jointly conduct the market analysis and impose *ex ante* regulation where appropriate. See Article 16(5) of the *Framework Directive*.

⁶⁵ See *Vodafone España*, at para. 99-101; see also case C-426/05 *Tele2 Telecommunication GmbH v Telekom-Control-Kommission* [2008] ECR I-00685, at para. 30.

⁶⁶ See Article 3(3a) of the *Framework Directive*: "Only appeal bodies set up in accordance with Article 4 shall have the power to suspend or overturn decisions by the national regulatory authorities."

⁶⁷ Or, in case of the national court of the last instance, have to.

⁶⁸ See *Vodafone España*, at para. 102.

⁶⁹ See Article 7(7) of the *Framework Directive*.

⁷⁰ See *Vodafone España*, 97.

⁷¹ See Article 263 of the TFEU.

⁷² Including any departure from recommendation adopted by the Commission.

national courts are free to annul decisions of an NRA where they depart from Recommendations, including Article 7(3) comments. In other words, it is for the national courts to test the legitimacy of any departure by NRAs from the Commission's Recommendations and comments. To this end, national courts are empowered to make a reference for a preliminary ruling to determine whether the Commission's non-binding acts are based on a correct interpretation of EU law.⁷³

It is only in those situations where the Commission uses its veto powers under Article 7(5) of the *framework Directive* that the proposed regulatory measure cannot be adopted; in such a case, consistent with principle of effective judicial protection, the Commission's decision is subject to judicial review by the Court of Justice. However, the Commission's veto power is limited strictly to interventions in clearly defined cases, namely, issues concerning market definition and findings of SMP. Notably, these instances deal with the fundamental question of whether or not a certain market will be regulated, but they do not address the question *how* the particular market has to be regulated. Such a limitation on the Commission's veto power is reasonable and justified in the light of the key principles and rules upon which the Framework is based, particularly the independence of decision-making by NRAs, taking into account the existing peculiarities in national/sub-national markets.

- *Conclusions*

The overall effectiveness of the Framework is conditioned upon the observance of a delicate institutional balance between the Commission and the NRAs. Under that institutional balance, the implementation of regulation is to be carried out exclusively by the NRAs, which are to be assisted by the Commission, through its Recommendations and the use of the EU consultation procedure. In turn, the legality of the NRAs' regulatory decisions, including the legitimacy of their departure from the Commission's Recommendations/comments, are subject to a full system of judicial review before the competent national courts,⁷⁴ which can be assisted by the Court of Justice where appropriate by references on interpretations of EU law. In addition, the Commission is granted a veto power with respect to two clearly defined and limited situations; it is the exercise of this latter power, unlike in the case of Recommendations/comments, which is subject to direct judicial control before the European courts. A departure from this institutional balance and division of powers could undermine the smooth and effective operation of the Framework to the prejudice of the ultimate objectives pursued by the framework.

⁷³ See *Vodafone España*, 102.

⁷⁴ See *Vodafone España*, 100-101.

4. 1. 2. The aftermath of 2009 amendments to the Framework

The Framework introduced in 2002 was subject to a periodic review by the Commission, with a view to determining the need for modification in the light of technological and market developments.⁷⁵ Accordingly, pursuant to a consultation process which began in 2006, the Framework was ultimately amended in 2009,⁷⁶ pursuant to the goal of address a number of concerns.

- *Article 19 amendment*

Article 19, whose purpose is to ensure the harmonised application of the provisions in the *framework Directive* and the *specific Directives* in order to further the achievement of the objectives set out in Article 8 of the *framework Directive*, was among the provisions subject to significant amendment. The amended Article 19 provides for a legal basis upon which the Commission may adopt not only Recommendations,⁷⁷ but also legally binding decisions. Following the amendments of 2009, a disagreement arose between the Commission and the member states as to the scope of the Commission's new power to adopt generally applicable decisions. The Commission is clearly of the view that the new power could also apply to remedies,⁷⁸ while 14 member states rejected this approach, stating that the new power is only (still) applicable to questions of market definition and the designation of SMP. The wording of Article 19(3) is not entirely clear as to whether or not the revised power to adopt decisions extends to remedies. What is clear, however, is that this power can only be exercised to address general regulatory approaches, and not individual notifications. In addition, and of particular importance, is the fact that the adopted decisions can only be designed to amend the *non-essential elements* of the Framework by supplementing it.⁷⁹

Thus far, the Commission has not adopted a decision under its new powers found in Article 19. Once adopted and, unlike a Recommendation, a decision would be binding on the addressee NRA. Accordingly, and unlike a Recommendation, a decision adopted under Article 19 of the *framework Directive* would be appealable to the European courts, where the issue can be tested as to whether the decision

⁷⁵ See Recitals 1 and 18 to the *Better Regulation Directive*.

⁷⁶ The amending acts were Better Regulation Directive, Citizens' Rights Directive and BEREC Regulation.

⁷⁷ Which it had the power to adopt already under the original Regulatory Framework.

⁷⁸ "The second thing I'd note is that, under the new powers, outcomes can be much more connected to goals. We don't just have to launch a recommendation and watch it sail off into the sunset, hoping that it reaches its planned destination – or to wait a few years to adopt a harmonisation decision if things do not turn out well." - European Competitive Telecommunication Association (ECTA), SPEECH/12/363 by Neelie Kroes, Vice-President of the European Commission responsible for the Digital Agenda, delivered on 21 May 2012. Available at: europa.eu/rapid/pressReleasesAction.do?reference=SPEECH/12/363&format=HTML&aged=0&language=EN&guiLanguage=en

⁷⁹ See Article 19(4) of the *Framework Directive*.

relates only to general regulatory approaches and supplements only non-essential elements of the regulatory framework.

Such an approach would retain the possibility of direct judicial control over the Commission's activities to test if the Commission is not overstepping its competence under the Framework. However, insofar as the Commission is willing to rely on Recommendations, whose content is not subject to direct judicial control before either the European courts or the national courts, and to use them in combination with the new powers contained in Article 7a (see below), it is arguable that it achieves a *de facto* regulatory monopoly with respect to some particular issues, while at the same time effectively evading direct judicial control while supporting a disproportionate role for itself in the application of the Framework.

- *Introduction of Article 7a and the Commission's stand*

Another very significant amendment of 2009 was the introduction of Article 7a to the *framework Directive*. Article 7a empowers the Commission to express its serious doubts in relation to particular remedies that an NRA proposes to impose, where those remedies might constitute a barrier to the internal market or where they may be incompatible with EU law.⁸⁰ Even though Article 7a does not grant the Commission any 'veto' powers, it is equipped with tools which allow it to effectively suspend the imposition of any remedies for a considerable period of time.

Thus, Article 7a of the *framework Directive* builds upon the Commission's original powers conferred under Article 7 and is designed to further the consistent application of the Framework, with the ultimate purpose of achieving a genuine and competitive internal market in electronic communications. Accordingly, it was widely anticipated that the Commission would exercise its Article 7a powers cautiously and in a comparable manner to the exercise of its powers under the original Article 7. For instance, in the period since the adoption of the Framework until the 2009 amendments came into effect, 'serious doubts'⁸¹ letters were a relatively rare occurrence, with the Commission exercising its powers respecting the rights and local expertise of NRAs to make independent decisions.

By contrast, 2012 has seen a massive escalation in the volume of 'serious doubts' cases under Article 7a with the number of cases running about 6 times the previous level, even before taking into account the cases where NRAs have changed their

⁸⁰ This was not the case under the already existent Article 7 of the *Framework Directive*. Under the latter Article, the Commission has the power to comment on any proposed measures, including comments in respect of remedies, however, Commission's serious doubts can only be expressed with respect to the definition of a relevant market different from any of the markets identified in the Recommendation and (non)-finding of SMP.

⁸¹ Also referred to as 'Phase II'.

approach following pressure by the Commission outside the formal Article 7 process. Indeed, as of the summer of 2012, 11 of the Phase II cases under Article 7a launched that year related to call termination rates. In most of these cases, the Commission launched Phase II proceedings merely because of *the timing* of implementation rather than the remedy itself, i.e. because the respective NRAs were not following the timetable established by the Commission in the *Termination Rates Recommendation*.⁸² Far from overseeing the independent decisions of NRAs and acting only when needed to ensure broad harmonisation, while recognising national market differences/peculiarities and the independent decision-making of NRAs, the Commission has increasingly sought to include itself into detailed decision-making process of NRAs. Notably, Commissioner Kroes points to this as a positive: *“We no longer have to be a mere commentator: we have a more proactive role in determining how our concerns can be addressed during the second phase proceedings. We don’t just leave it to the national authority to take our comments on board.”*⁸³

In some cases, such as that on Dutch termination rates,⁸⁴ the Commission is also putting itself in a direct conflict with independent national judicial system and asking the NRA to act contrary to clear and legally binding orders of the national courts. Needless to say, such an approach by the Commission is difficult to reconcile with the general principles of EU law, given that an independent national judicial system is an integral aspect of national sovereignty and that decisions by national authorities should be appealed nationally and only referred to the European courts if the national courts consider that guidance is necessary in the application of EU law, for which case reference for a preliminary ruling to the Court of Justice is possible. In addition, as discussed above, it is the national courts that are the appropriate institutions to determine whether or not a departure by an NRA from the Commission’s comments/Recommendations is legal.

Such a sharp rise in the number of Phase II cases under Article 7a inevitably begs the question of whether the decision-making by NRAs has suddenly deteriorated (thereby creating regulatory uncertainty) or whether the Commission has itself injected a new element of regulatory uncertainty into the process. More specifically in the context of call termination, is it no longer the case that national peculiarities are relevant for the imposition of remedies and that therefore the Commission is

⁸² LV/2012/1356, EE/2012/1352, BG/2012/1318.

⁸³ European Competitive Telecommunication Association (ECTA), SPEECH/12/363 by Neelie Kroes, Vice-President of the European Commission responsible for the Digital Agenda, delivered on 21 May 2012. Available at: europa.eu/rapid/pressReleasesAction.do?reference=SPEECH/12/363&format=HTML&aged=0&language=EN&guiLanguage=en

⁸⁴ Case NL/2012/1285: voice call termination on individual mobile networks in the Netherlands.

reasonable in dictating to NRAs when and what actual remedies can be imposed? As a matter of common sense, it cannot be the case that the decision-making powers of so many NRAs could have deteriorated so sharply so as to explain the enormous amount of Phase II proceedings under Article 7a of the *framework Directive*. This is especially the case since the central role of NRAs with respect to the imposition of regulatory remedies is emphasised in the case-law of the Court of Justice.⁸⁵ Equally beyond doubt is the fact that the specific conditions in relevant markets across different member states mean that actual *ex ante* remedies, including the precise methodology and scope thereof, as well as the timing of their implementation, may need to be adapted to those specific conditions on specific relevant markets in particular member states.

It therefore needs to be asked whether the Commission has injected greater certainty or uncertainty into the regulatory process by virtue of its new wave of interventions against NRA decisions under the Article 7a mechanism. Prior to the 2009 amendments, and in particular the introduction of Article 7a to the *framework Directive*, the *Termination Rates Recommendation* would have served in its proper context and (legal) purpose: the NRAs would have been free to depart from its terms having taken utmost account of it, and the legality of any such departure would have been subject to judicial review before the competent national courts. In addition, given that the “utmost account” standard should be satisfied upon provision of sufficient reasons by an NRA, the duty to take utmost account of the Commission’s Recommendations would impose a qualitative standard which would in turn prevent the regulatory process from being disrupted by opportunistic appeals seeking to reinforce the Recommendations.

Consequently, the Commission’s recent attitude post-2009 amendments suggests that, by combining the Article 19 *advisory and non-appealable* Recommendations, in particular the *Termination Rates Recommendation*, with the new powers under Article 7a which manifest themselves in *advisory and non-appealable letters/Recommendations*, the Commission considers these new powers under Article 7a to be a way to dictate a particular solution to NRAs.⁸⁶ In other words, the new powers can be used to suspend any decision with which the Commission disagrees (which departs from the *Termination Rates Recommendation*, for example) to exert pressure on the relevant NRA to change its decision to comport with the

⁸⁵ See *Vodafone España*, at paras. 72-74.

⁸⁶ Ironically and, perhaps, unsurprisingly Commissioner Kroes refers to Article 7 as to a tool “quietly” helping the Commission to achieve regulatory outcomes. See European Competitive Telecommunication Association (ECTA), SPEECH/12/363 by Neelie Kroes, Vice-President of the European Commission responsible for the Digital Agenda, delivered on 21 May 2012. Available at: europa.eu/rapid/pressReleasesAction.do?reference=SPEECH/12/363&format=HTML&aged=0&language=EN&guiLanguage=en

Commission's views. This institutional pressure is reinforced by the prospect of opportunistic and costly litigation by the affected undertakings prompted by the particular NRA's 'non-compliance' with the Commission's position. As a result, the powers of an NRA to impose market-specific remedies on a timely basis are limited, and their ability to tailor solutions to particular conditions existing in the relevant markets defined with due account to national peculiarities, is undermined.

The Commission thus seems to be establishing a *de facto* regulatory monopoly power over regulation in the field of electronic communications, and in particular with respect to the imposition of remedies, thus far primarily in relation to mobile termination services markets. A particularly telling example in this respect is two Recommendations adopted under Article 19 of the *framework Directive*: the *Termination Rates Recommendation*, and the *NGA Recommendation*.⁸⁷ More precisely, the Commission does not appear to treat these two Recommendations equally. With respect to the *NGA Recommendation*, the Commission is mostly seeking to use Phase II proceedings where there is disagreement about the SMP issue, which by implication means a proposal to remove/not to impose asymmetric *ex ante* regulation as such. However, unlike in the cases concerning the *Termination Rates Recommendation*, the Commission is not seeking to become involved in the details of regulatory remedies. Accordingly, the Commission through its administrative practice appears to consider that the *NGA Recommendation* has a lesser 'standing' under EU law than the *Termination Rates Recommendation*. Such an arbitrary nomenclature surely cannot be conducive to regulatory certainty.

DG Connect's Commissioner Kroes seems to have given the reason for such a relatively cautious approach by the Commission in relation to the *NGA Recommendation*: "*To be frank – the conversation between the Commission and NRAs on how best to achieve NGA roll-out AND effective competition is a lot more complex than as regards termination rates.*"⁸⁸ In contrast, in relation to the *Termination Rates Recommendation*, Commissioner Kroes openly suggests that the reason of the extraordinary number of Phase II cases under Article 7a is due to the NRAs not strictly following the terms of that Recommendation.⁸⁹

⁸⁷ Commission Recommendation of 20 September 2010 on regulated access to Next Generation Access Networks - C(2010) 6223.

⁸⁸ European Competitive Telecommunication Association (ECTA), SPEECH/12/363 by Neelie Kroes, Vice-President of the European Commission responsible for the Digital Agenda, delivered on 21 May 2012. Available at: europa.eu/rapid/pressReleasesAction.do?reference=SPEECH/12/363&format=HTML&aged=0&language=EN&guiLanguage=en

⁸⁹ "The majority of [Phase II] cases, indeed 11 out of the 16, concerned mobile termination rates. That doesn't really come as a surprise: we are approaching the 2013 target date for implementation of termination rates based on efficient costs, announced in the Commission's 2009 Recommendation, and lately a lot of national authorities have been notifying remedies reaching beyond that date." Similarly: "Let's look, again, at mobile

Seen in the context of both sets of Recommendations, this suggests the overall situation is anything but conducive to legal certainty. At one level, it is ironic that, in relation to the NGA issue, the situation is supposedly “complex”, and therefore the Commission is reluctant to intervene as a ‘supra-regulator’. By contrast, the Commission feels more confident about the minutiae of regulation with respect to call termination rates, thereby engaging in an extremely pro-active regulatory role by involving itself in the detail of individual remedies to be imposed on a particular SMP undertaking in the particular relevant market. While this type of approach might be legally intolerable because the Commission is using its newly acquired powers under Article 7a in order to establish a *de facto* binding effect of its *Termination Rates Recommendation* adopted under Article 19, it nevertheless appears to be at odds with the fundamental principles that underpin the legal certainty which originally imbued the Framework.

- *Interim summary*

The Commission’s approach to the interpretation of the *Termination Rates Recommendation* is unlikely to be what the European Council thought to be the case at the time the 2009 amendments to the framework were adopted. The discussion in this section considers whether the Commission’s current approach effectively neuters the NRAs in their capacity to regulate termination services markets. The Commission seems to be seeking to eliminate national discretion and seems to consider the market conditions in all member states being the same or, at least, not worthy of being taken into account. In addition, the Commission’s attitude undermines the fundamental legal principles on which the Framework is based, thereby putting its rationale and effective operation in jeopardy. Moreover, on some occasions the Commission effectively seeks to substitute the Commission for national courts, which goes against the very constitutional system of the EU.

In addition, the Commission’s role of a super and supra regulator renders the Article 7a process is becoming unmanageable for both operators and regulators. This includes BEREC, which simply does not have the resources to advice on such a volume of Phase II cases. In addition, it seems doubtful if such a situation is in accordance with the rationale for the establishment of BEREC, whose envisaged role and tasks are extensive.⁹⁰ However, BEREC cannot cope with the workload imposed

termination rates. Our second phase powers were not used because of mere technical differences with the NRAs. But in cases where notified remedies would have failed to achieve the objective defined in 2009” - European Competitive Telecommunication Association (ECTA), SPEECH/12/363 by Neelie Kroes, Vice-President of the European Commission responsible for the Digital Agenda, delivered on 21 May 2012. Available at: europa.eu/rapid/pressReleasesAction.do?reference=SPEECH/12/363&format=HTML&aged=0&language=EN&guiLanguage=en

⁹⁰ BEREC Regulation, Articles 2 and 3.

by the Commission through its questionable use of its new Article 7a powers.

Finally, the Commission might be seen to be creating a conflict in a very important sector of electronic communications between the fundamental principles underpinning the Framework, thus including the powers/competence of NRAs and even national courts, and the actual regulatory process heavily influenced by the interventionist stance of the Commission. Whereas what the Commission seems to be doing is arguably creating a greater level of harmonization in final regulatory results, it is very questionable if that comports with the legal certainty that should be associated with a framework that is purports to satisfy the twin goals of effective judicial review, on the one hand, and subsidiarity in decision-making, on the other.

4. 2. The New Zealand experiment: legislating for term assurance

New Zealand has always been known for its novel approach to regulation. For several years after the passage of the Commerce Act 1986, it adhered to a policy of regulating network industries entirely on the basis of that competition law alone. The years following its passage showed the system struggling in particular with telecommunications, notably in the lengthy proceedings known as *Clear Communications*. The case revolved around the conditions (notably the price) at which a competitor could under competition law has access to the network of the incumbent operator Telecom New Zealand. The matter was finally resolved by New Zealand's highest court, the London-based Privy Council, which ruled that a pricing process of the 'retail minus' kind, known as the "Efficient Component Pricing Rule",⁹¹ was lawful. This led to prices less hospitable to competitors than those established in other jurisdictions, and corresponding pressure to align the law more closely with that of other jurisdictions.

Accordingly, the law was amended to make provision under certain circumstances for *ex ante* regulation to be introduced after negotiations between the parties failed. However, the New Zealand regime remained very alive to the adverse effects of regulation on investment and innovation. The Telecommunications Act 2001 was subsequently amended to contain (at Section 18) the following provision:

"... (2A) To avoid doubt, in determining whether or not, or the extent to which, competition in telecommunications markets for the long-term benefit of end-users of telecommunications services within New Zealand is

⁹¹ See J-J Laffont and J Tirole, *Competition in Telecommunications*, 2000.

promoted, consideration must be given to the incentives to innovate that exist for, and the risks faced by, investors in new telecommunications services that involve significant capital investment and that offer capabilities not available from established services.”

Other sectors continued to rely on light-handed forms of regulation, based on information disclosure. This was adopted in airports and electricity distribution. From 2001 onwards, electricity distribution was also subject to a “thresholds regime” which bore some resemblance to CPI-X regulation though firms could breach their “threshold” and not be subject to regulatory control. The results were not always entirely satisfactory, and more *ex ante* regulation was introduced.

4. 2. 1. The “input methodologies”

As *ex ante* regulation grew, the New Zealand legislature, drawn by what one commentator called ‘the allure of certainty’,⁹² passed legislation which required the Commerce Commission (the regulator, as well as the competition authority) to set out the ‘input methodologies’ or regulatory approaches, which it would use for at least the next seven years.

Accordingly, the Commerce Amendment Act 2008 contains part 4, subpart 3 which relates to input methodologies. Section 52R provides that the purpose of subpart 3 is:

“to promote certainty for suppliers and consumers in relation to the rules, requirements, and processes applying to the regulation, or proposed regulation, of goods or services under this Part.”

This is to be accomplished by development of input methodologies, the scope of which is large, as the following extract from the Act shows:

“(1) The input methodologies relating to particular goods or services must include, to the extent applicable to the type of regulation under consideration:

(a) methodologies for evaluating or determining the following matters in respect of the supply of the goods or services:

(i) cost of capital:

(ii) valuation of assets, including depreciation, and treatment of revaluations:

⁹² David Blacktop, ‘Input methodologies - the allure of certainty’ NZ Lawyer, 23 July 2010

- (iii) allocation of common costs, including between activities, businesses, consumer classes, and geographic areas:
 - (iv) treatment of taxation; and
- (b) pricing methodologies; and
- (c) regulatory processes and rules, such as:
- (i) the specification and definition of prices, including identifying any costs that can be passed through to prices (which may not include the legal costs of any appeals against input methodology determinations under this Part or of any appeals under section 91 or section 97); and
 - (ii) identifying circumstances in which price-quality paths may be reconsidered within a regulatory period; and
- (d) matters relating to proposals by a regulated supplier for a customised price-quality path, including:
- (i) requirements that must be met by the regulated supplier, including the scope and specificity of information required, the extent of independent verification and audit, and the extent of consultation and agreement with consumers; and
 - (ii) the criteria that the Commission will use to evaluate any proposal.
- (2) Every input methodology must, as far as is reasonably practicable,
- (a) set out the matters listed in subsection (1) in sufficient detail so that each affected supplier is reasonably able to estimate the material effects of the methodology on the supplier; and
 - (b) set out how the Commission intends to apply the input methodology to particular types of goods or services; and
 - (c) be consistent with the other input methodologies that relate to the same type of goods or services.
- (3) Any methodologies referred to in subsection (1)(a)(iii) must not unduly deter investment by a supplier of regulated goods or services in the provision of other goods or services.”

The coverage of the input methodologies comprises airports, electricity distribution, and gas distribution and transmission. In the energy sector, different input methodologies (and regulatory instruments) are used for large and for small firms.

4. 2. 2. Designing the methodologies

The Commerce Commission set about devising the methodologies. The time-table, which was extended by six months in the course of the process, began in December 2008 with the publication of an initial discussion document; the release of guidelines in mid-2009; the publication of draft guidelines in early 2010; the promulgation of the methodologies at the end of 2010. The two year period included numerous rounds of consultations and conferences.

The object of the exercise is to give firms a high(er) degree of certainty over how they will be regulated. Inevitably, this involves the inclusion of considerable detail. For example, the methodology for cost allocation and asset valuation for the larger electricity distribution companies consist of 8 pages of definitions and formulae which the regulator will use to establish the opening regulatory asset value, depreciation, and revaluation of assets required to implement the current cost approach to asset valuation.⁹³

In relation to the cost of capital, the airports methodology contains seven pages of detailed formulae for setting the cost of capital, setting out a methodology and formula for setting the weighted average cost of capital and indicating how the values of the various elements of the formula are to be established.⁹⁴

The various input methodologies established for the sectors and groups of firms are not uniform in their approach. Greater certainty did not entail inter-sectoral consistency, though, as we note below, consistency may enhance certainty. This arose because the Commission sought to accommodate differences in the requests of different groups of regulated firms. There remains, however, a common thread running through some parts of the various methodologies, for example in relation to asset valuation and the cost of capital.

After publication, various aspects of the methodology were appealed by the affected parties. An electricity distribution company, Vector appealed successfully to the High Court over whether the Commission was obliged to publish an input methodology in respect of the approach it proposes to take to setting prices. That Judgment was overturned by the Appeal Court, but the Commission won in the New Zealand Supreme Court in November 2012.

This was essentially a process-based appeal. A further largely process-based appeal against the Commission was rejected in December 2011. Several firms have also

⁹³ Commerce Commission, Electricity Distribution Services Input Methodologies Determination, 2012, pp. 95-104.

⁹⁴ Commerce Commission, Input methodologies determination applicable to specified airport services pursuant to Part 4 of the Commerce Act 1986 (the Act), 2010, pp. 25-32.

appealed 'on the merits' against the substance of the methodologies. Hearing of these appeals started before the end of 2012. Under Section 52 of the Act, the input methodologies stand until the appeal process is completed.

4. 2. 3. Evaluation

It is clearly early days to evaluate the effects of the New Zealand approach. It is, however, abundantly clear that the process of giving greater certainty by this means is a long and exacting one. It seems that such certainty can only be achieved by making the methodologies detailed. Thus the determination for airports (which are not subject to price control) runs to 45 pages and the accompanying reasons paper (with appendices) is 358 pages long. This level of detail also makes the methodologies vulnerable to appeal on a wide variety of 'on the merits' grounds.

An initial preparation period of nearly two years and a litigation period of more than two years calls into question the methodologies' 'shelf life' - particularly whether there should be established for a greater number of years than seven.

But the key question is: what is the incremental effect of a commitment to particular methodologies? The answer to this question is likely to be context-specific. As section 2.4 demonstrates, regulated firms have rights of appeal to regulatory decisions, the practical outcome of which depends upon a range of circumstances. Thus a radical and unheralded departure from a previously established regulatory approach might in some jurisdictions enhance the chances of success of an appeal, especially if inadequately notified in advance. This at the least requires changes to be consulted upon.

This does not protect firms from all forms of pre-announced change or 'instability'. But it is notable that some regulators are extending price control periods to seven or even more years. Such price controls 'fill in the numbers' of the input methodologies and reduce uncertainty to an even greater degree than a methodology can.

Thirdly, as noted above, governments or legislatures in some jurisdictions are focusing on achieving greater consistency in regulation. This might go beyond adherence to general principles of 'better regulation'.⁹⁵ For example, it might take the form of recommending or imposing a single method to establish the cost of capital.

The previous discussion suggests that the incremental effects of pre-announced regulatory methodologies depend on individual country circumstances. In other

⁹⁵ In the case of the UK government, the principles for economic regulation are: accountability, focus, predictability, coherence, adaptability and efficiency. *Principles for Economic Regulation*, BIS, April 2011.

words, the discussion is part of a wider debate about the design of regulatory institutions for network industries to achieve an appropriate balance between consumer protection and incentives to invest in sunk (and hence appropriable) assets. What emerges from the work of Levy and Spiller⁹⁶ is that a number of alternative institutional designs, involving interrelationships among the legislature, the regulator and the courts, can produce a satisfactory outcome. A legislative requirement for input methodologies is one strategy in which can be adopted in this battle, and it will be particularly appropriate when substitute arrangements are lacking.

Paradoxically, the relevant institutions in New Zealand seem well defended against regulatory variability or opportunism. That is to say: regulation is used relatively sparingly by an independent regulator whose decisions are subject to a succession of avenues of appeal. In this environment, its incremental effect of input methodologies is likely to be small. Where it would be needed is an environment in which regulatory instability or opportunism is allowed to take effect, there being little check on such behaviour, with dire consequences for service users. Levy and Spiller give some examples of this. The situation of many member states of the EU is less favourable than New Zealand (though better than in some of Levy and Spiller's illustrations). It may therefore either be worth specifying methodologies more fully in Directives, or requiring regulators to commit to particular approaches.

4.3. Commitment to the valuation of sunk assets: the Regulatory Asset Base⁹⁷

4.3.1. Introduction

Investors in network infrastructure usually have to make extensive sunk investments, which are vulnerable to a form of expropriation by the regulator which allows the recovery of variable costs but sets prices below the level which permits the full recovery of depreciation and provides an adequate return on capital. Even the fear of this eventuality may increase the cost of capital, or, in the limit, cause investment to dry up. This makes it in the long run interest both of customers and of investors to offer some kind of qualified commitment that this will not happen.

One form of such a qualified commitment is for the regulator to use in price controls

⁹⁶ B Levy and P Spiller, *Regulations, Institutions and Commitment*, Cambridge University Press, 1996.

⁹⁷ This section was contributed by Jon Stern, of City University, London. He is grateful for advice and assistance with this paper from Neil Griffiths-Lambeth and Stefanie Voelz. Particular thanks go to Chris Bolt and Jonathan Mirrlees-Black. Responsibility for the views expressed and for any remaining errors is solely the responsibility of the author.

and publish a Regulatory Asset Base (“RAB”),⁹⁸ which records a regulatory valuation of assets on which investors might reasonably expect a return of and on capital. RAB protection has de facto become the major perceived underpinning of investor expectations for UK infrastructure industries, particularly against (a) retrospective ‘asset-taking’ and (b) against the future stranding of assets. RABs exist in a number of other countries but they are only significant as a commitment device in countries where network infrastructure utilities (or at least the network elements) are privately rather than publicly owned.

There is no mention of RABs in UK primary legislation. The current British RABs evolved following the privatization of the UK network infrastructure industries as a regulatory device to reassure investors – and hence keep down the cost of capital. They are primarily intended as protection against actions by regulators or governments that could lead to asset stranding. *However, precisely because they have no explicit legislative support, their reliability as a commitment device depends crucially on regulators keeping to the spirit as well as the letter of RAB commitments.* If UK regulators were seen by investors as violating that spirit, then the RAB’s credibility as a commitment device could disappear very quickly – and would probably be virtually impossible to retrieve. In this regard, investor perceptions are almost as important if not more important than observed developments.

The importance of RABs as a commitment device is not, however, just in their existence. It arises primarily out of the regulatory context in which they are set, updated and revised. *The key conclusion of this section is that the role of the RAB as a commitment device is a consequence of the quality of its implementation rather than from the definition of the RAB per se.* Well defined RABs in insecure regulatory environments offer little as a commitment device; whereas, at least in principle, the same degree of commitment could be offered by a secure regulator using a different mechanism. It is just that RABs have been accepted as a useful device for UK and other infrastructure regulators and their relative success – and familiarity – has provided a reputational support. Indeed, it may be that the success of the UK RAB concept arises precisely because it does **not** have legal force. This, unlike the US ‘rate base’ model, allows for the regulator to amend contracts via an ordered review, revision and renegotiation of licences⁹⁹.

In the US, investor protection is given via explicit legal protection e.g. by the 1944 Supreme Court *Hope Gas* ruling and subsequent administrative law

⁹⁸ Also known as a firm’s RCV (regulatory capital value) or RAV (regulatory asset value).

⁹⁹ Where licences represent explicit or implicit contracts. See Jon Stern (2012) “The Relationship between Regulation and Contracts in Infrastructure Industries: Regulation as Ordered Renegotiation”, *Regulation and Governance*.

determinations¹⁰⁰. That provides more certainty but, arguably, at considerable legal and management cost. However, the US ‘rate base’ approval model does not provide total protection to investors either in theory or practice since only “efficiently incurred” costs are included in the rate base and “inefficiently incurred” costs can be excluded. In practical terms, costs can be – and have been - disallowed from the rate base as not passing the efficiency test (viz. US disputes and disallowances of some nuclear power station construction costs in several states in the 1980s). This undoubtedly had a chilling effect on US nuclear plant construction but, it does not appear to have had wider effects on the rate base approach as a commitment device to support private investment in electricity or other infrastructure network industries. This may be because the strong and explicit legal underpinnings effectively and clearly limit cost exclusions.

The RAB alternative, although more fragile in theory, appears in practice to provide considerable protection relative to the US model via reputational effects on the cost of capital. Primarily because of the way that UK regulators have treated its revision, it regularly scores highly in ratings agency appraisals¹⁰¹. It also appears to allow the easier negotiation of change between regulators and companies e.g. as regards unbundling and the introduction of competition¹⁰². This was successfully achieved and without too much difficulty in UK natural gas, in telecoms and in the recent vertical unbundling of the Scottish vertically integrated power companies. However, quite what the RAB protects and how it can be reallocated with changes to the market and corporate structure of the industry has become a major issue of contention in the English water industry. This example shows well the expectations of the parties and the limits on the regulator from modifications to the RAB that are perceived as threatening its security (e.g. in debt contracts).

4. 3. 2. The evolution and development of RABs

The key concept behind the RAB is Financial Capital Maintenance (“FCM”). This was used as one of the control methods for the UK nationalized industries from the late 1980s. Hence, FCM – and the RAB – address the issue of whether the financial capability of the company is being maintained intact. This clearly relates to but is separate from whether the physical supply capacity of the company is being maintained intact i.e. Operating Capital Maintenance (“OCM”).

¹⁰⁰ In the Hope Valley Gas case, the US Supreme Court interpreted the 14th Amendment of the US Federal Constitution to prohibit “regulatory takings”. This ruling became a cornerstone of US utility regulation.

¹⁰¹ See, for instance, Moody’s Global Infrastructure Rating Methodology, 2009 and country infrastructure company rating surveys.

¹⁰² See Stern (2012) op cit and Section 5 below.

- *Key RAB concepts*

In general terms, a starting point for the value of the RAB is the net book value of assets, where the net book value can be expressed as:

$$\text{Gross current cost of assets} + \text{provision for depreciation} = \text{Net book value}^{103}$$

Outside the UK, the RAB is simply the net book value. However, for the privatized UK network infrastructure industries, the RAB is a lot lower than this because, at privatization in the 1980s, the assets were sold at a substantial discount. At the extreme, for the England and Wales water industry, the current replacement cost (or MEA value) of the assets in 2010 prices was about £224 billion but the privatization proceeds were £5.3 billion¹⁰⁴. The difference is the privatization discount. Hence, following Vass (1999):

$$\text{Net book value} - \text{Privatization discount} = \text{RAB}$$

For infrastructure industries in the US and other countries which have been in private ownership since their inception or for very long periods, the value of the RAB is the same as the net book value. Similarly, for state owned industries where there is a RAB, there is no discount of this kind which needs to be taken into account. Hence, in both cases, the value of the RAB is equal to the net book value of the assets.

Interestingly, a number of EU countries also have RABs but ‘simple’ ones. For instance, Austria, Belgium, Finland, France, Germany, Ireland, Italy, Netherlands and Spain all have electricity and gas network RABs for electricity and gas transmission/transport although in several cases, the companies are fully state-owned. Somewhat surprisingly, the electricity network RABs in Belgium and France include working capital as do the gas network RABs in Belgium, Germany and Italy¹⁰⁵. Looking more widely, Australia and New Zealand both have RABs for many of their infrastructure industries – as do Brazil and Chile for their water industries.¹⁰⁶

4. 3. 3. RABs in the UK and other member states

The current state of UK RABs and the debate around them can be summarized as follows:

- *There is general agreement that RABs are an effective commitment device for*

¹⁰³ See Peter Vass (1999) “Accounting for Regulation”

¹⁰⁴ See Ofwat (2010), “RD 04/10 Regulatory Capital Values 2010-15”. The privatization proceeds in 1989 prices were £5.3 billion gross.

¹⁰⁵ See IERN (2010) “Overview of European Regulatory Framework in Energy Transport”

¹⁰⁶ See section 3 ii of this report for an interesting way in which New Zealand procedures for asset valuation are stabilised by regulatory commitment.

natural monopoly network elements of infrastructure companies – provided that regulators keep to the spirit as well as the wording of the rules;

- *RABs have maintained a low cost of capital for privately financed infrastructure investment in the areas which they cover – typically much lower than would be paid under project finance contracts¹⁰⁷;*
- *The key to RAB success is that it provides effective protection against asset stranding e.g. by regulators arbitrarily changing the rules on depreciation or asset classification;*
- *The implication for the unbundling of companies has thrown up – and continues to generate – major RAB-related disputes, primarily over its allocation to monopoly network relative to other assets and particularly over the reallocation of privatization discounts).*

Disagreements and debate continues on whether RABs should be applied beyond the natural monopoly network elements of infrastructure companies, cf. the water industry debate and suggestions for RABs on large investments in competitive sectors (e.g. nuclear generation).

We discussed the composition of some EU RABs above. Here we outline some of the regulatory arrangements for RABs in the energy sector in Germany, Italy, Netherlands and Portugal¹⁰⁸.

The key results are shown in Table 5 below.

Table 5: Regulatory characteristics of RAB energy regimes in four EU countries

<i>Country and company</i>	German electricity and gas network companies (2010)	Italian electricity transmission - Terna (2012)	Italian gas transport - Snam (2012)	Netherlands gas transport - Gasunie (2012)	Portugal electricity transmission - Ren (2011)
<i>RAB published by regulator</i>	No	No <i>(Published by company)</i>	No <i>(Published by company)</i>	Yes	No <i>(Average RAB published by company)</i>

¹⁰⁷ In some cases, they may be lower in project finance contracts e.g. where everything is tightly tied down in fixed contracts and risks have effectively been eliminated. The UK offshore transmission contracts seem to be an example of this.

¹⁰⁸ The data for these illustrative examples are drawn from Moody's Investor Service Notes 2010-12 and I am very grateful to them for allowing me to use them in this paper.

<p><i>Other major RAB regime issues</i></p>	<p>Only equity funded proportion of assets acquired prior to the year of the price review is adjusted for inflation.</p> <p>Equity-funded portion capped at the lower of (i) actual equity and (ii) 40%, but based (unlike revenues) on asset specific price indices (max 40% of assets).</p> <p>RAB only reviewed at price review not during a period.</p> <p>Planned enhancement investment fully remunerated separately.</p> <p>Unplanned investments only remunerated once added to RAB.</p>	<p>Generally supportive legislative with predictable and stable AEEG regulatory track record</p>	<p>Generally supportive regulation</p>	<p>Major regulatory uncertainties introduced by</p> <p>(i) retrospective reduction of Gasunie RAB; and</p> <p>(ii) reducing 2012-13 tariffs via an imposed one-off repayment of Gasunie’s fee charges levied since 2006</p>	<p>Regulatory stability track-record good, but some political interference in the past.</p> <p>ERSE has had tariff setting independence since 1999</p>
---	--	--	--	---	--

Source: Moody’s Reports summarized by J Stern

The table shows varying degrees of regulatory support for the RAB as an effective commitment device. In general, Moody’s Investors Service Ltd (“Moody’s”), the rating agency, uses the UK regulatory regime as a benchmark for Europe in terms of stability and predictability of the relevant framework. In that respect, the Italian framework is relatively close to the UK framework, whilst the German framework is still comparably young and undergoing changes. It is also perceived as less transparent with the RAB not being published. The Netherlands would have got high marks if there had not been the major recent retrospective RAB and related reductions. Similarly, the assessment of the Portuguese framework is also affected by some political interference in the past.

4. 3. 4. RABs as a protection against asset stranding

In the US “rate base” system, all efficient (and efficiently procured) assets are, by law, guaranteed cost recovery. Further, there are common federal guidelines on

depreciation rules, etc. which are applicable at state level as well as federal level. This provides very considerable security to investors – and it allowed the major expansions of privately financed electricity and gas networks in the 1950s and beyond at very low debt coupon rates. Once US infrastructure assets are incorporated in the rate base, their economic remuneration is effectively assured; the threat of asset stranding is very low indeed.

The US rate base system is stronger than the protection offered under RABs and supporters of it argue that a stronger statement of the right to cost recovery should be written into European regulatory systems¹⁰⁹. It is true that the US system provides very strong protection against stranded asset losses, but it is not complete. For instance, assets have to be accepted into the rate base as “efficient”. The disallowance of various nuclear costs in the 1980s – and the subsequent bankruptcy of some investor-owned utilities – shows it has its limits as a protection against stranded asset assets. In addition, there are other limitations, including:

- *the combination of rate base protection with rate of return regulation led to weak incentives to improve efficiency and, in some cases, to ‘gold-plating of investments’;*
- *the strength and legal structure of the rules mean that legal separation within vertically integrated utilities is extremely hard if not impossible. This is an important reason why US electricity companies have adopted Independent System Operators (“ISO”) rather than Independent Transmission System Operators (“ITSO”) both at State and multi-State level¹¹⁰. They also greatly complicate the introduction of competition into vertically integrated industries.*

In the UK, RABs do not provide the US-level of protection against asset stranding but do have more flexibility. Although not explicit licence conditions, they are integral to price reviews so that regulatory price determinations that involve a revaluation of the RAB (e.g. via changes in depreciation rules) can be appealed to the Competition Commission. That, in practice, means that there is a lot of pressure on regulators against making changes in RAB values that are radical and/or hard to justify. At worst, regulators may be required to offset adverse RAB rulings with concessions to the regulated company arising from other parts of the settlement (e.g. on rate of return, length of price cap or other issues).

¹⁰⁹ See, for example, Graham Shuttleworth’s 2007 Memorandum to the House of Lords Select Committee on Economic Regulators.

¹¹⁰ See Jon Stern, Martin Cave and Guido Cervigni, CERRE (2011), “The role of systems operators in network industries”, Chapters 3 and 4.

The less than totally legally binding framework is important as it allows easier evolution via the degree of flexibility. However, since it is *bounded and accountable flexibility* with strong appeal rights, the role of the RAB as a commitment device has not, in general been undermined by the absence of a US-style cost recovery obligation on past assets. In this context, Richard Nourse's comment on the financing issues arising from Ofwat's competition proposals is particularly apt:

“Investors do not expect Ofwat to provide a “silver bullet” to take away the risk of regulatory change from the current reviews. It is recognized that Ofwat could not say something like *We guarantee that as a result of all this competition stuff, we will not touch £1 of RCV*”¹¹¹. [Nourse's emphasis]

However, in practice, there have been some serious disputes between UK infrastructure companies and their regulators over RAB/RCV redefinition. These provide useful information on how far UK RABs in practice provide protection against 'regulatory takings'.

4. 3. 5. Evidence on the effectiveness of the RAB as a commitment device

There is little direct evidence e.g. of proposed or actual RAB changes on share prices or debt coupons. However, there is some, like the impact of the 2001 Ofgem decision on the Transco gas RAB reported earlier. There is also no question that the ratings agencies pay considerable attention to RAB regimes and their security. In what follows, we consider what evidence there is, starting with the ratings agencies.

- Ratings agencies and the RAB

All the main credit ratings agencies operate in the infrastructure area and they have similar concerns and methods. However, in what follows, I focus on Moody's which has been very active in the British water and RAB protection debate.

Moody's explains its approach to rating privately financed regulated water companies in its global regulated water utilities methodology, published in 2009. Another methodology, published in the same year, applies to regulated electric and gas networks. Both methodologies set out four key factors that constitute the rating agency's analytical framework.

RAB security is not specifically considered under the methodologies but the overall country regulatory environment and asset ownership model is one of the factors, accounting for 40% of the overall score. Within this factor, Moody's currently assign a score for stability and predictability of the regulatory environment and this

¹¹¹ Richard Nourse (2009), “Competition proposals and financing issues: A report for Ofwat”. ofwat.gov.uk/competition/review/rpt_com_nourse260209.pdf

accounts for 15% of the overall score.

Moody's currently assign the regulatory regimes in the UK a score of Aaa for the regulatory stability and predictability sub-factor. This reflects the historic stability and predictability of the regimes with a more than 20 year history and reliance on clearly defined risk allocation principles, which have been consistently applied and transparently disclosed. Whilst the indicated rating from the relevant methodology is only one (important) consideration in Moody's overall assessment, any perceived weakening of the regulatory regime would, according to the agency, most likely result in negative rating pressure.

According to Moody's, the RAB is a key part of the UK regulatory model and a weakening of regulatory commitment in this area, if not otherwise offset, would likely result in negative pressure on the scoring for the sub-factor. However, the agency does not have a scoring mechanism specifically for 'RAB commitment'. They believe that it would be challenging to devise such a scale and, in any event, RAB is only one part of the regime and not the sole focus¹¹².

Note that Moody's concerns with the quality of the regulatory regime within which RABs are embedded rather than RAB definitions per se echoes the main argument of this paper.

4. 3. 6. Summary

This section has set out the arguments why RABs can provide an effective regulatory commitment device for infrastructure industries and, in particular, for their networks. This effectiveness, however, seems to depend at least as much on the security of the regulatory setting within which RABs operate and are revised. The quality of that setting includes the effect of both formal, legal frameworks and informal experience e.g. on the transparency and consistency of regulatory decisions affecting the RAB and related financing issues.

The UK scores highly on these elements as, elsewhere in the EU, does Italy. Other countries do less well. The recent retrospective Netherlands decisions against Gasunie spoil an otherwise good record and it will be interesting to see whether and, if so, how long it will take for the Gasunie credit ratings and financing costs to recover.

It is not clear how far the UK experience can be reproduced in different environments. It evolved over a 20 plus year period after the privatization of the

¹¹² See Moody's Global Infrastructure Finance: Rating Methodology August 2009 – Regulated Electric and Gas Networks and communication with Neil Griffiths-Lambeth, Senior Vice-President, Moody's.



main British infrastructure industries. The RAB approach is by no means a panacea and 'RAB-fetishism' is not uncommon. Nevertheless, it does seem to have provided a useful safety net for keeping down the cost of capital for privately financed infrastructure investment and versions of it seem to have been successful in Latin America as well as in Australia – at least in countries with strong regulatory frameworks and track-records.

5. Conclusions

This paper began by suggesting that the notion of regulatory ‘stability’ can be thought of in narrow and broad senses – as involving either no changes or changes that are tractable and manageable. The paper has pointed out, moreover, that rates of change in regulation have to be considered in context. This suggests the value of adverting to three main aspects of regulatory stability: controls, timescales and tractability. The first of these focuses on whether controls or incentives are subjected to changes; the idea of timescales assesses rates of regulatory change with reference to the time horizons that are involved in the delivery of relevant services; and the concept of tractability prompts attention to the predictability and manageability of the regulatory changes at issue.

As for strategies for effecting changes in regulation at lowest overall cost, it has been seen that regulators have developed a variety of strategies for ‘re-regulating’. This paper has reviewed those strategies and has argued that we can distinguish between seven major types, the potential of which, in a given context, can be evaluated with reference to an identifiable framework of issues.

In developing that framework it has been argued that a regulatory system is optimally stable if it effects changes in a way that maximises the excess of benefits over expected costs relating to such changes. As for calculating these costs, it has not been contended that it is feasible to use a formal cost-benefit approach but it has been suggested that a frame for assessing-regulation strategies can be generated by building, on clarity about three issues: sources of change; varieties of re-regulation strategy; and the varieties of costs and benefits that are caused by shifts in regulation. Table 3 demonstrated how such a framework could be used to assess choices of re-regulation strategy by addressing the main costs and benefits to be expected from different combinations of change source and re-regulation strategy.

Regulatory changes, of course, tend to be encountered more in clusters than in solitary unity. The paper, accordingly, turned attention to the packages of reforms that generate such dramatic changes in the utilities and other sectors in Europe. The above review of changes in the telecommunications, energy and railways sectors revealed, however, that quite dramatic mutations of regulation can be effected without giving rise to serious concerns about stability if steps are taken to ensure that changes are tractable.

In order to triangulate these findings, three more detailed case studies of re-regulation were considered above. These focussed on major efforts to re-regulate, by using novel tools, in European telecommunications, New Zealand legislation and the use publication by the regulator to the valuation of sunk assets, and hence of a

qualified or implied commitment to allow recovery of those costs by an efficient regulated firm.

In relation to the regulation and re-regulation of European telecommunications, the complexity of Commission-NRA interactions is a key element in the process, especially as regards the nature of decision-making in the EU legal hierarchy and the enforceability of measures falling short of being classified as “legislation”.

The New Zealand legislation requiring the regulator to commit for a period of seven years to certain ‘input methodologies’ in a price control process is an interesting attempt to use legislation not to impose regulatory methodologies directly, but to require the regulator to impose them on itself. This might make sense in the case of a regime in which a regulator frequently gives way to temptation to behave opportunistically, and in which there are few checks and balances by way of appeal processes. In practice, neither of these conditions applies to the regulator in question, so the incremental benefit of the provision in New Zealand is likely to be limited.

There are variants on this theme, however. One is for the legislation directly to impose the methodologies.¹¹³ This is unlikely to be a good idea, not least because of the difficulty of correcting any errors. Another variant is employed in Australia in the energy sector, where one body (the AEMC) is charged with making adjusting the rules, while another (the AER) administers them. The New Zealand process has the two tasks performed sequentially by a single body.

This case study involves use of the public recording at intervals by the regulator (normally as part of the price control process) of a valuation of the assets in use by the regulated company, as a regulatory asset base or RAB. This is widely used by regulators, and it is argued above that it is to be preferred to the US alternative to give comfort as to the protection of sunk assets via use of a high level legal principle set out in a 1944 US Supreme Court judgment.¹¹⁴ The RAB is only a qualified commitment, since with prior preparation and consultation it can with something like consent be changed through a regulatory process; in other words, in the terminology used above, they are a potentially tractable instrument. As liberalisation proceeds and the scope of price control diminishes, the relevant assets may have to sink or swim on the basis of their own productivity in a competitive market. The attention paid to RABs by ratings agency provides some indirect evidence of their utility. We believe that they have a useful role to play, especially in cases of long-

¹¹³ For example, some primary legislation has specified the statistical model, the formula and the data sources by which the rate of return allowed to the regulated firm should be calculated.

¹¹⁴ See section 3.3 above.

lived assets used in conditions of persistent monopoly.

To summarise, stability in regulation is a slippery concept. It operates at different levels and over different time horizons. It is a broader concept than simply constancy of existing arrangements, since it recognises that a variety of circumstances can make it desirable or even necessary to change regulatory arrangements, and that the adverse effects of such change can be mitigated by forewarning, consulting and (more controversially) in certain circumstances sugaring the pill for parties losing from the change.

The above analysis throws up seven key messages for regulators and regulated firms:

Regulatory changes may be negative or positive in their overall effects, and have a differential effect on different actors – for example consumers and investors. The more ‘redistributive’ they are, the more contentious they will be.

Regulatory change is not a problem, per se, but changes that are low in tractability tend to be problematic. Even changes that are positive in substance may be effected by re-regulation strategies that are unduly wasteful of resources. Changes have both substantive and procedural dimensions and both of these will be addressed by astute regulators.

The expected gains and losses associated with a given regulatory change can be assessed with reference to the major categories of costs and benefits associated with that change.

The main sources of regulatory change can be identified as can the main varieties of re-regulation strategy.

Many regulators have experience of using re-regulation strategies that will lower the costs of regulatory change – but few regulators approach the issue of re-regulation strategy in a structurally organised manner.

A challenge for many regulators is that changes are imposed on them from the policy level – the legislature and/or the government. This implies that re-regulation strategies should be put into effect across levels of government.

Regulated firms can argue with some force that regulators should refrain from introducing regulatory changes without first considering the range of potential re-regulation strategies that can limit costs (or maximise benefits) and without applying the most suitable of these.

Appendix 1 - A review of examples of re-regulation strategies

This review of examples of re-regulation strategies focusses on experience in the utilities sectors in six European countries: Spain, Portugal, the United Kingdom, Italy, Ireland and France. Seven main kinds of device were encountered in the review and the breakdown of these forms the basis for both Table 2 above and the discussion below.

Examples of strategies will be numbered so that broad conclusions on the potential of the different strategies can be tabulated in Table 4 below.

Term assurance

Example 1: Term assurance on objectives

In Spain, in 2009, the Comisión Nacional de Energía (CNE) commenced a ten step process which materialized in a document called “Planes de Actuación de la Comisión Nacional de Energía” which explained in detail how the CNE intended to cope with the regulatory changes introduced by the EU in the "third regulatory package" on the Energy industry. The objective was to prevent the industry of the CNE's intentions and generate an opportunity for the industry to comment on the plans. The "Planes de Actuación" includes a 5 year term assurance on adherence to its stated strategic objectives (Section 2 Para. 3).

Example 2: Term assurance on interpretative ruling

In France in 2011, The Authority for regulation of Postal and Electronic Communications ‘ARCEP’ issued Decision 2011-0483 on price controls for mobile voice call termination of operators Orange France, SFR and Bouygues Telecom and made the decision binding for a stipulated period: 1st July 2011 to 31st December 2013. (In the decision ARCEP dealt with call termination, a wholesale service involving financial flows between operators. Pursuant to Article I of L. 38 of the Code des Postes et Communications Electroniques, the Authority deemed Orange France, SFR and Bouygues Telecom to have a significant influence on the relevant markets, and ruled, accordingly, that both non-tariff obligations (including accounting separation) and tariff price control obligations (such as a fixed ceiling for tariffs) were applicable.)

Notice and Information

Many regulators undertake to consult industry on proposed regulatory changes and the examples below are a few selected citations from the many possible.

Consultations on substantive changes in regulation

Example 3: Consultation on reform

In Spain the Comisión Nacional de Energía's "Planes de Actuación de la Comisión Nacional de Energía" (noted in Example 1) includes (at Section 4 (f)) an undertaking to consult the industry and to collect opinions regarding reform processes. It also includes a transparency commitment assuring that all processes will be procedurally transparent. The creation of the "Planes" document was preceded by high levels of industry opinion, the issue of notices on the contents of the revised objectives and widespread communications with market actors.¹¹⁵

Example 4: General consultative rule

In Spain, when Ministries start consultations amongst market actors, they usually include the opinion of the National Energy Commission. (See the Comisión Nacional de Energía Publication Number 9/2012 – on the Public Review of Ministerial Reform Proposals.) A consultative document will also include the Recommendations of the Consultive Council for energy¹¹⁶.

In public consultations, market actors are thus supplied with not only the Ministerial proposal but also the opinions of both the CNE (the independent regulator of the energy market) who has no policy making power but is in charge of enforcing regimes approved by Ministers, and the Consultive Council in which operators representatives, consumer representatives and other market actors participate.

In Spain it is usual that when a Minister issues a regulatory proposal there will be consultation of the general public and stakeholders and that the proposal will include the intended decree text for commentary and the overview of the reasons for such an initiative.¹¹⁷ For an example of the establishing of consultative councils and their role in giving opinions to the CNE and the Government on regulatory proposals and planned enforcement strategies see Congress Law 34 of 1998 - Transitory Article 11.

More generally, Congress Law 50 of 1997 - Article 24 offers a general provision on consultation covering regulators and Ministers. It states, *inter alia*, that if a proposed provision affects the rights and lawful interests of citizens, they shall be heard for a reasonable period (and with reasonable notice), directly or through recognised representative organizations whose purposes directly relate to the object of the provision. It is the primary legislative rule that mandates regulators, ministers and other decision makers to consult stakeholders or the general public under

¹¹⁵ See generally: ec.europa.eu/energy/gas_electricity/legislation/third_legislative_package_en.htm

¹¹⁶ Available at: cne.es/cne/doc/publicaciones/cne14_12.pdf

¹¹⁷ See also: Consultation Process for the procedure of energy efficiency certification of existence buildings at: minetur.gob.es/energia/es-ES/Novedades/Paginas/AnuncioSEEdificioexistentes.aspx

determined circumstances.

Example 5: Consultation on market definition

An instance of consultation from the telecommunications sector in Spain is the July 2012 Public Consultation of the Comision de Mercado de las Telecomunicaciones (CMT) on the definition and analysis of the minor market of public network access in a fixed location for residential clients, the designation of operators with significative market power and the imposition of specific obligations.¹¹⁸

Example 6: General obligation to consult, electricity

In Portugal there is a general obligation of consultation regarding changes in the electricity code. Decree/Law 97 of 2002, which contains the statute of Entidade Reguladora Dos Servicos Energeticos (ERSE), sets the general terms in which consultation and prior discussion should be undertaken between the regulator and the regulated parties. The Decree/Law states that all the changes in the electricity codes shall be preceded by a public consultation process which involves the participation of the stakeholders including regulated companies, consumer representatives and institutional entities. ERSE must present a proposal for the given regulatory changes and must address the case for each alteration it intends to make to the Regime for Service Quality. This proposal should be put to concessionaries and to the licencees for consultation. ERSE must respond in 60 days to all the consultations made to it by all market actors (Article 19) and, before approving any rule, ERSE must consult either the Consultive Council or the Tariff Council for their opinions. ERSE must publish the projected rules on its web page and must open a 30 day period for all market actors, consumers' licencees and concession contract parties to comment on the proposed rules.

Under Article 40, the Consultive Council of ERSE can express its views on any general decisions the ERSE makes on its regulatory approach, objectives, lines of action, and particularly in the area of electricity, decisions referring to quality and security standards, changes in the rules of the Electric sector in which the ERSE is competent and any other regulatory matters other than those that relating to the tariff definition. The preamble of all rules approved by the ERSE must contain a review of all comments received and how they were analysed or if they were used/ignored in order to determine the ultimate text. Under Article 48 the representations of the Tariff Consultive Council must be published on the ERSE web page.

¹¹⁸ cmt.es/consultas-publicas?p_p_id=101_INSTANCE_IF6E&p_p_lifecycle=0&p_p_state=normal&p_p_mode=view&p_p_col_id=column2&p_p_col_count=1&_101_INSTANCE_IF6E_struts_action=%2fasset_publisher%2fvie_w_content&_101_INSTANCE_IF6E_uriTitle=120705_consulta_mercado1&_101_INSTANCE_IF6E_type=content&redirect=%2fconsultas-publicas&pag_anio=2012&

Example 7: General obligation to consult, telecommunications

In Portugal there is a general obligation of public consultation in the telecommunications sector. Decree/Law 309 of 2001 - Article 6 (m) requires the Autoridade Nacional de Comunicacoes (ANACOM) to promote the processes of public consultation and representation of interests with regard to the introduction of new services or technologies. Article 11 (2) demands that, before approval or modification of any relevant regulation ANACOM must inform the Minister, the concessionary or licensed entities, operators, the various registered service providers and consumers associations of generic or specific interest in the area of communications, and must give them access to the texts at issue. The interested parties have access to all the suggestions that have been made and have 30 days in which to make representations. The report that proposes a regulation serves as the basis for the decisions, with necessary reference to criticism or suggestions made with regard to the draft.

Article 35 ensures the role of the advisory council as a body for consultation, support and participation in definition of the general guidelines for the activity of ANACOM. It comprises members of all market actors including consumers, operators of the various telecoms services amongst others.

Example 8: Consultation on a new accounting methodology

In the UK, on 27 November 2008, the FSA published Consultation Paper 08/20 on changes in prudential rules (notably capital requirements) for Personal Investment Firms. It is an example of a consultation on a change in accounting approach. That Consultation Paper was followed by a discussion paper and a feedback paper. Finally, the consolidated rules after the consultation were published on Policy Statement 09/19 in November 2009.

Example 9: Consultation on new regulatory approach

A United Kingdom example of a complex, multi-stage consultation process followed the expiry, on March 31, 2011 of the UK Mobile Call Termination rules that were then in force. To prepare for the new regime that would be instituted, OFCOM undertook a complex market review procedure that included various consultation processes regarding different elements of the mobile call termination regime. The first consultation, on May 2009, OFCOM "sought views on different approaches to regulating MTRs, including potentially radical reforms such as removing all rules on call termination or requiring that MCT be priced at zero (termed 'bill and keep')." After receiving multiple answers, OFCOM initiated a second consultation on April 2010. It "explained why, having considered the options, and in light of the responses received we thought that capping MTRs, based on some measure of cost, would lead

to better outcomes for consumers than alternative approaches." This second consultation included the cost modelling proposal for the new regime and received a very significant number of responses and comments from market actors. On July 2010 and September 2010 OFCOM issued further information requests to the 4 national MCPs. After this discussion and interaction, OFCOM published on March, 2011 its final decision regarding Mobile Call Termination.¹¹⁹

Example 10: General approach to consultation

A general approach to consultation is set out by OFCOM in the UK. OFCOM has published a guide to its consultation process in which it set up the guidelines for public consultations. It states: (i) OFCOM decisions must be based on evidence and they need to take account of the views of those who have an interest in the outcome. (ii) Consultation is an essential part of regulatory accountability the means by which those people and organisations affected by OFCOM decisions can judge what is done and why. (iii) OFCOM will give reasons for decisions and will give an account of how the views of those concerned helped shape those decisions.

These guidelines cover instances where OFCOM is publicly consulting on policy proposals. It does not cover OFCOM investigatory functions or areas of OFCOM work in which OFCOM has published specific guidelines. The areas to which the guidelines do not apply include: The handling of standards complaints and cases (in programmes and sponsorship); and procedures for handling fairness and privacy. Nor do the guidelines apply to areas where Ofcom only seeks representation from one party, which may be the case, for example, if OFCOM proposes to amend a broadcasting licence. They also do not apply to consultations concerning the giving of a consent, approval or Recommendation by OFCOM.

In the UK and a number of other jurisdictions, the process of Regulatory Impact Assessment (now termed 'Impact Assessment' in the UK) requires that a regulator publishes its intended regime changes, consults on these and justifies reforms by showing that the estimated benefits exceed anticipated costs.¹²⁰

Example 11: Consultation on changes in regulatory objectives

Some regulators will consult stakeholders on changes in regulatory objectives. Thus, in November 2011, in the UK, OFWAT carried out a consultation on charges for new connections. At issue here was a modification of OFWAT's regulatory principles. The regulator adopted a procedure that was designed to reset its regulatory objectives

¹¹⁹ See: stakeholders.ofcom.org.uk/binaries/consultations/mtr/statement/MCT_statement_Annex_6-10.pdf and stakeholders.ofcom.org.uk/binaries/consultations/mtr/statement/MCT_statement.pdf

¹²⁰ See generally: C. Radaelli and F. De Francesco, 'Regulatory Impact Assessment' in R. Baldwin, M. Cave and M. Lodge, *The Oxford Handbook of Regulation* (Oxford U P, 2010).

by agreeing them with the stakeholders.

Example 12: Consultation on tariff reforms

An Italian example of consultation involves discussions concerning the reform of tariffs through the passing of new primary legislation. In February 2012, the Authority for Electric Energy and Gas engaged in Deliberation 28/12/R/GAS, which modified and added provisions to Deliberation ARG/gas/08.

The Authority invited firms to discuss various proposals to reform the regulation of service tariff measurement (meter readers) on natural gas distribution networks (DCO 17/11). The aim was to reform the regulation of said tariffs, with a view to improving cost-efficiency and an optimal distribution of profits for distributing firms. Also in 2011/2012 the Authority for Electric Energy and Gas adopted a similar consultative procedure when modifying measures dealing with applicable remedies against companies failing to comply with the unbundling requirement, namely the separation of accounting and administrative functions.¹²¹

Example 13: Consultation on objectives

In Ireland, in 2012, the Commission for Communications Regulation 'COMREG' consulted on the obligations to be imposed on operators who enjoy significant market power (SMP). The EC had suggested that a number of markets would be susceptible to *ex ante* regulation. These markets were then reviewed in an Irish context by COMREG and obligations were imposed on operators which were designated to have significant market power. One such market was Wholesale Broadband Access (WBA) and Eircom Limited was designated to have SMP in that market.¹²²

On the issue of transparency COMREG stated that, having considered the consultation response and other relevant evidence, it had decided to amend the existing transparency obligation to no longer require publication of minimum price floors for WBA components offered by Eircom in resale or end-to-end WBA. Instead, the minimum price floors for such components would have to be submitted to COMREG to demonstrate compliance with the obligation not to margin/price squeeze (by setting the price for a downstream service so low relative to an upstream input that the user of the regulated upstream input could not compete profitably).

¹²¹ Consultation DCO 26/11

¹²² See: Access and discussion: consultation document No. 10/108, "Wholesale Broadband Access: Further consultation to Consultation Document No. 10/56 and draft decision in relation to price control and transparency" - published on 22ndDecember 2010.

Consultations on calculative methodologies

Example 14: Consultation on calculative methodology

The Comision de Mercado de las Telecomunicaciones (CMT) June 2012 Public consultation regarding the calculation methodology of the net cost of universal service.¹²³

Example 15: Consultation on calculative methodology

In the UK Electricity sector, OFGEM has a record of consulting on such matters as decisions on changes in assessing the depreciation of assets. In 2010-2011 the RIIO Framework Decision Document dealt with a change in the technique for calculating the depreciation of assets. The Decision Document was followed by a Public Consultation Process regarding the adequate economic asset lives for gas transmission and distribution and for electricity distribution.¹²⁴

The public consultation was followed by a decision letter on March 31, 2011 - This letter consolidated the results of the consultation process and included the regulator's comments on the arguments received in the consultation. Following consideration of the consultation responses, the Gas and Electricity Markets Authority ("the Authority") decided that it would use an average expected economic asset life of 45 years for new assets, with straight-line depreciation. The new asset life would only apply to new investment from the commencement of RIIO-ED1 on 1 April 2015. Existing assets would continue to use the existing 20 year asset life.¹²⁵

Example 16: Consultation on assessing asset lives

This Irish communications example involves consultation on a change of regulatory approach to assessing regulatory asset lives. The calculation and application of depreciation charges on fixed assets is relevant to the majority of regulated wholesale prices. Most of these wholesale prices ultimately feed into retail prices charged by operators. COMREG was minded, in 2009, to operate on the basis of decreases to the regulatory asset lives for certain asset categories and increases in the case of some others. On 17th February 2009, COMREG issued consultation document No. 09/11: a "Review of the Regulatory Asset Lives of Eircom Ltd". It invited comments on COMREG's preliminary view on the appropriate regulatory asset lives for Eircom's fixed line network.

¹²³ cmt.es/consultas-publicas?p_p_id=101_INSTANCE_IF6E&p_p_lifecycle=0&p_p_state=normal&p_p_mode=view&p_p_col_id=column-2&p_p_col_count=1&_101_INSTANCE_IF6E_struts_action=%2fasset_publisher%2fview_content&_101_INSTANCE_IF6E_urlTitle=120622_consulta_publica_su&_101_INSTANCE_IF6E_type=content&redirect=%2fconsultas-publicas&pag_anio=2012&

¹²⁴ ofgem.gov.uk/Networks/Policy/Documents1/ED%20asset%20lives%20consultation%2021000114.pdf

¹²⁵ ofgem.gov.uk/Networks/Policy/Documents1/assetlivedecision.pdf

Example 17: Consultation on method of calculating returns

Since 2003, various aspects of the Irish economy and financial markets, as well as the structure of the telecoms industry more generally, and of Eircom in particular, have changed. As a result, COMREG has reviewed the method used by the regulator to calculate the adequacy of a return for Eircom. Consultation on a proposed new approach was instituted by Consultation Document No. 07/88 of November 2007. Decision D01/08 followed the consultative process.

COMREG concluded that: 1) A nominal pre-tax weighted average cost of capital (“WACC”) of 10.21% would be used for the purpose of Eircom’s separated accounts; and as a basis for allowing Eircom an adequate rate of return for regulatory purposes, including the setting of Eircom’s regulated wholesale prices. 2) The WACC of 10.21%, superseded the WACC of 11.5%, as set out in Decision 4.3 of Decision Notice No. D3/03 (Document No. 03/14) insofar as it pertained to Eircom’s regulated wholesale prices. 3) Notwithstanding, the WACC of 11.5% as set out in Decision 4.3 of Decision Notice No. D3/03 (Document No. 03/14) would continue to apply to and continue to have full force and effect in relation to retail narrowband access prices, until such time as COMREG decided otherwise.

Example 18: Consultation on new methods of calculating costs

In France, the Authority for the Regulation of Postal and Electronic Communications (‘ARCEP’) has consulted on new methods of calculating costs in the face of changes. In 2011 ARCEP sought to determine whether the replacement of copper networks by fiber optic networks required adjustments to the then current method of annualization. It was found that the annualization method used for local loop assets maintained its relevance, as it ensured reimbursement of capital expenditures actually incurred without leading to underpayments/over payment. However, adjustments to the depreciation periods of active local loop were justified by the transition from copper to fibre.¹²⁶

Example 19: Consultation on modelling network costs

ARCEP similarly carried out a public consultation on the techno-economic model to be adopted to manage mobile operators’ network costs (31st January 2011) and the Authority’s consultation on the draft decision on the definition of price control for mobile voice call termination operators Orange France, SFR and Bouygues Telecom (26th April 2011, and see: Decision 2011-0483 on price controls for mobile voice call termination of operators Orange France, SFR and Bouygues Telecom for the period 1st July 2011 to 31st December 2013, complements Decision No. 2010-1149).

¹²⁶ See Consultation Document of 29th March 2011

Consultations on drafting

Sometimes regulators will consult affected parties on the specifics of drafting new rules and regulations or licence terms. This gives such parties an opportunity to press for forms of words that minimise transitional costs.

Example 20: Consultation on licence conditions

In 2010-12 in the UK, OFGEM carried out a two-tier consultation process regarding all the ring fence conditions of the Network Operator Licences. The first consultation paper was published on March 2010.¹²⁷ After receiving feedback from this consultation paper OFGEM published a second consultation in March 2011.¹²⁸

The results of that consultation process have still not been published, but on March 13, 2012 OFGEM published an open letter saying: ‘The consultation included a set of proposed licence changes. Our intention is to update the licence drafting to reflect some of the comments we received and to informally consult with network companies to improve the drafting as far as possible.’

Workshops

A device that some regulators use in order to discuss and manage transitions of regulatory approach is the workshop.

Example 21: Workshop on adapting to market changes

OFCOM holds workshops with stakeholders to hear their initial thoughts regarding major market changes. One example relates to mobile call termination and cost modelling.¹²⁹ These workshops are alternative forms of consultation and often involve potential changes to delegated legislation or to codes.

Transition negotiations and compliance discussions

Example 22: Discussions on changes and compliance obligations

In Portuguese electricity regulation, the regulator, ERSE issues a Commercial Relationships Code in the Electricity Sector (CRCES). Article 142 of this Code provides that whenever a change is determined in the regulation governing consumption measurement, the operator must present within 30 days a plan about how it is going to cope with the change and how it is going to modify or substitute the measurement equipment. Article 248 of the Code states that ERSE may make Recommendations to market participants in order to be considered for complying

¹²⁷ ofgem.gov.uk/Networks/Policy/Documents1/IA_Ring_Fence_Review_3%20Mar%2010_final.pdf

¹²⁸ ofgem.gov.uk/Networks/Policy/Documents1/Ring%20Fence%20Mods%20Consultation.pdf

¹²⁹ stakeholders.ofcom.org.uk/binaries/consultations/mobilecallterm/slides.pdf

with the principles and operating rules of the market. Depending on the seriousness of the facts the ERSE may also send these Recommendations to other monitoring and supervising entities. Under Article 299 of the Code, specified entities may ask the ERSE for a non-binding opinion regarding the interpretation of the regulation contained in the CRCES.

These devices help the operators to identify potential breaches to the modified code before being subject to sanctions. The potentially negative impacts of regulatory change are considerably diminished because operators can rely on the regulator's opinion and because they have to be alerted in advance about changes. The aim is ways to manage change in a non-punitive way.

Example 23: Discussion of transitional arrangements

In the UK energy sector OFGEM has sought to manage certain regulatory changes by combining consultations with discussions on transitional arrangements, advance notice provision and financial concessions that reflect the costs of change. In 2010-2011 OFGEM issued RIIO Framework Decision Document (RIIO stands for: Revenue = Incentives + Innovation + Outputs). This document determined a change in the depreciation technique applicable to assets: "When considering depreciation we will focus on how best to balance the costs paid by existing and future consumers, taking account of the expected economic life of assets and uncertainty in the future use (and usefulness) of assets."

The change, it was announced, would be put in place from the time of instituting the electricity Distribution price control in 2015. The 2010-2011 document also stated: "Where the implementation of any aspect of RIIO in a single step, and in particular our financeability principles, would create financeability concerns for an efficient network company, we will put in place transition arrangements to ensure financeability. Transition arrangements include the possibility of a glide path (over one price control period). Any increase in cash flow risk will be remunerated appropriately through the allowed return." (p. 4).

The Decision Document was followed by a Public Consultation Process regarding the adequate economic asset lives for gas transmission and distribution and for electricity distribution.¹³⁰

The public consultation was followed by a decision letter on March 31, 2011 - This letter consolidated the results of the consultation process and included the regulator's comments on the arguments received in the consultation. OFGEM stated that, following consideration of the consultation responses, it had decided to use an

¹³⁰ ofgem.gov.uk/Networks/Policy/Documents1/ED%20asset%20lives%20consultation%2021000114.pdf

average expected economic asset life of 45 years for new assets, with straight-line depreciation. The new asset life approach would only apply to new investment from the commencement of RII0-ED1 on 1 April 2015. Existing assets will continue to use the existing 20 year asset life.¹³¹

Example 24: Discussion of proposed transition process

In the Portuguese telecommunications sector, the institution of a new item of delegated legislation has been accompanied with provisions that offer stakeholders an opportunity to discuss the transition process and to participate in associated decision-making processes. Thus, Council of Ministers Resolution Number 26/2009 dealt with the transition from analogical to digital terrestrial television. The Resolution created a monitoring group to overview the transition process. This monitoring group was composed, inter alia, of representatives of all broadcasters, consumers, and competition authorities.

Example 25: Discussion of compliance practices

In the Portuguese financial services sector, the Comissao do Mercado de Valores Mobiliarios (CMVM) will regularly assess and disclose, after consulting with the relevant stakeholders the market practices that may be accepted or not, reassessing the same whenever necessary, as well as their characteristics, terms and conditions in conformity with the principles laid down in Article 358 and the other applicable legal and regulatory framework, transmitting the respective decision to the Committee of European Securities Regulators.¹³²

Example 26: Discussion of modes of transposing Directives

Again, in the Portuguese financial services sector, the Comissao do Mercado de Valores Mobiliarios (CMVM) engages in consultation on the way in which it transposes European Directives. In Consultation Paper 2/2012, the CMVM put out for public consultation a draft of legislation that purports to transpose into the domestic legal framework Directive No. 2010/73/EU on the prospectus to be published when securities are offered to the public or admitted to trading and Directive No. 2004/109/EC on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market.

Example 27: Discussion of regulated firms' calculative methodologies

One way for a regulator to manage change is to discuss the methodologies that will

¹³¹ See: ofgem.gov.uk/Networks/Policy/Documents1/assetlivedecision.pdf

¹³² Decree/Law 486/99 Public Consultation Mandate of Financial Regulation Changes - Article 360.

be used by the regulated firm to calculate such matters as costs. In Ireland, Eircom is required to notify COMREG when it proposes to change material methodologies within its cost accounting systems. This allows COMREG to agree/disagree such proposals before they are implemented in the cost accounting systems.

Example 28: Collaborative monitoring of changes

In Italy the Authority for electric energy and Gas manages change by working closely with Terna (the company managing the national transmission network) to monitor the effects of the new regime on the national electricity system by means inter alia of cost-benefit analysis.¹³³

Example 29: Undertakings to review regulation

In the French postal and telecommunications sector, the Authority for Regulation of Postal and Electronic Communications (ARCEP) has, on certain issues, dealt with change by undertaking to engage in reviews of its decisions, taking on board the evolving technological and market conditions. Thus when an extensive raft of legislation was implemented to reflect a shift in the market (in which operators made major deployments of fibre networks to the arteries of major towns) (Decision No. 2009-1106) ARCEP promised a review and clarification by the end of 2013.

Transition Programmes, Timescales and Reviews

Example 30: Periods of grace

The Portuguese financial services regulator, the Comissão do Mercado de Valores Mobiliários - CMVM. Has sought to manage regulatory transitions by providing certain operators with a period of grace during which they have time to adjust to new regulatory rules. An example from 2003 concerns Regulation 16/2003 on The Accounting Regime of Collective Investment Organizations.

This regulation substantially modified the former accounting regime applicable to Collective Investment Organizations. It provided a programme for implementation as follows. For those organizations registered as Special Investment Organizations, the regulatory effect was immediate. For all other Collective Investment Organizations, the new regime was only applicable from January 1st/2005, and, for the 2004 fiscal year, it allowed such organizations to continue in accordance with the former accounting regime contained in Regulation 31/2000.

Example 31: Stays on enforceability

In the Spanish electricity sector, the Spanish Congress transitory articles relate to

¹³³ See Deliberation 84/2012/R/EEL: introducing new sections to the network code.

special circumstances in which the provisions of the law will not be enforceable against certain market actors before a stipulated time elapses.

Under Law 54 of 1997 - Transitory Article 12, for instance, those distributors who were operating before January 1st, 1997, to whom Royal Decree 1538/1987 about tariff determination of administrator firms of the electric sector, was not applicable, could opt for the special tariff regime that the Government will set for them. When the Government modifies the economic regime applicable to distribution activity established in the Royal Decree 2819/1998, and that modification deals with such distributors, they must adhere to that regime when it is in force. This can, in no case, be before January 1st, 2007.

Example 32: Term assurance on transition

In Portugal Council of Ministers Resolution Number 26/2009 dealt with the transition regime from analogical to digital terrestrial television. This item of delegated legislation included a three year term assurance for the transition – which allows that period to create all the necessary conditions for the transition.

Example 33: Stays on enforceability.

In the Spanish electricity sector, articles and transitory articles have been used to deal with the special circumstances in which the provisions of new laws law will not be enforceable against certain market actors before a timeframe elapses.

Royal Decree 1634 of 2006 – Additional Article 25: The low voltage consumers who have opted to purchase their electricity on the open market may not return to their energy contract rate before twelve months. The high voltage consumers who have opted to purchase their electricity on the open market may not return to their contract rate. Consumers who have opted to purchase their electricity at a contract rate may change the type of contract on the open market at any time, provided that the minimum requirements are met. Royal Decree 1634 of 2006 - Additional Article 26 extended the deadline for implementation set out in paragraph 2 of the second transitional provision of Royal Decree 436/2004 of 12 March, until the entry into force of the rule that amended the legal and economic framework for electricity production in the special regime. Once the transitional period was over those facilities remaining in it, automatically migrate to the category, group and subgroup that correspond to them according with the new standard, based on their usage of technology and fuel. Those facilities keep their registration.

Royal Decree 1634 of 2006 - Transitory Article 3:1. Determines an ad-hoc tariff regime for those customers benefiting from the rate B.0 for street lighting who have nor been installed proper measuring equipment to merge into other tariffs. This, because of the demise of special rate B.0. The ad-hoc tariff regime is to be applied

until all measuring equipment is duly installed.

Example 34: Period of notice

Portugal provides a simple example of a period of notice for implementing a new set of regulatory rules. Law 51 of 2011 - Article 106 Creates the Municipal Fee for Rights of Way (MFRW) for "The rights and charges as regards the implanting, crossing or passing over of systems, equipment and further resources of undertakings providing publicly available electronic communications networks and services, at a fixed location, of a public or private municipal domain". Article 128 (2) gives a 90 day term assurance for the MFRW to enter into force.

Example 35: Period of grace

In the UK, Ofcom has used periods of notice to facilitate change. On 8 July 2010 OFCOM made a Statement on Changes to the Mobile Number Porting Process. This instituted changes to the number porting process to make it easier for users to take their numbers with them when changing operators. The regulation also seeks to comply with the advances and requirements in European law. The changes will only be in effect from April, 2011, that is, 9 months after the approval of this statement. Changes to the Mobile Number Porting Process - Before the July/2010 statement, the draft was submitted to stakeholders for consultation in April, from the consultation process, OFCOM recognizes changes including the implementation time that changed from OFCOM's preferred 6-month period to a 9 month period.

Example 36: Period of grace

The Portuguese water sector provides an example of a strategy to cope with change that was criticized because of the insufficiency of the timeframe allowed. Decree/Law 243 of 2001 regulated new standards of quality for water distribution. Article 18 of this law determined the compliance schedule for the new standards. All operators were to comply with the standards by December 25/2003. This short period was criticized as being "unrealistic" in the text "Texts on Regulation #3" published by the Regulatory Authority ERSAR P.26.¹³⁴

Example 37: Phased changes

Phased changes have been used in Portugal to ease regulatory transitions in the energy sector. Decree/Law 75 of 2012 - Referred to the agreements between Portugal and the EU on the elimination of the regulated tariffs for electricity and natural gas before January 2013. The Decree included the elimination of regulated

¹³⁴ See: ersar.pt/Website_en/ViewContent.aspx?SubFolderPath=%5cRoot%5cContents%5cSiteEN%5cMenu_Main%5cDocumentation%5cERSAR_Publications&Section=Menu_Main&BookTypeID=22&FolderPath=%5cRoot%5cContents%5cSiteEN%5cMenu_Main%5cDocumentation&BookCategoryID=1

tariffs to final customers and dispositions to incentivize competition in the market. As to coping with change, the Decree/Law provides for the gradual elimination of the tariffs. See, for particular measures: Decree/Law 75 of 2012 Article 2 - The elimination of regulated tariffs occurs for Major Consumers (+10,35KW/h) from July 1, 2012 and for domestic consumers from July 1, 2013. Those costumers qualified as "vulnerable" can, after July 1, 2013 exercise a right to be charged a tariff that is equivalent to the now existing regulated tariff.

Decree/Law 75 of 2012 Article 4 - If major consumers do not opt for the open electric market, the incumbent must continue to serve them, using the regulated transition tariff determined by the ERSE at least until December 31, 2014.

Decree/Law 75 of 2012 - Article 6 - Information Duties - Includes duties both for ERSE and the Operators. ERSE must publish all the information regarding changes to the open market, the transition approved tariffs and the operators available. Operators must include in the invoices all the information regarding the elimination of regulated tariffs, the new regime and the possibilities to switch operator if decided.

Example 38: Piloting

In relation to the changes referred to in Example 37 a further transitional strategy has been used – that of piloting. Directive 1/2012 took into account the Government extension of the "pilot period" of the energy mobility system; the ERSE also extended the tariff determination for that period.

Example 39: Transitional arrangements

Transitional periods are also used in the UK financial services sector, notably regarding changes in the rules regarding prudential capital requirements for Personal Investment Firms. On 27 November 2008, the FSA published Consultation Paper 08/20 to open the discussion regarding the changes in prudential rules for Personal Investment Firms. That Consultation Paper was followed by a discussion paper and a feedback paper. Finally, the consolidated rules after the consultation were published in Policy Statement 09/19 of November 2009.

The policy statement about changes in rules regarding prudential includes a transitional arrangement for implementation in which the policy will only come in full force on December 31, 2013. Before then, the firms have to adjust gradually to the new capital requirements, time requirements and limits on subordinated debts. The transitional arrangements were included in an annex table to the policy statement and were part of the consultation process.

Example 40: Technical preconditions for change

In the Italian energy sector the implementation of regulatory changes in some areas

has been made conditional on the achieving of relevant technical preconditions. In March 2012 the rules were changed so that when a customer changed from provider A to provider B, any outstanding bills due to B can be claimed by A. The due amount is called *corrispettivo Cmor*. This instance involves the revision of the regime regulating clients' information leading to indemnity for Cmor utility bills. The implementation of a complete indemnity regime was postponed until all the necessary technology, namely SII (data sharing technology specific to electric energy & gas markets, law 129/10) & RCU become fully operational. Only then would the Authority legislate on definite regulation within the objectives laid out by TIQV, an integrated text specifying quality standards for electric energy & gas services (as approved by ARG/com 164/08).¹³⁵

Parallel concessions; and compensation

Example 41: Compensation for new cost

The Spanish energy sector has seen concessions used in introducing regulatory changes. The former Law 54 of 1997 - Transitory Article 6 recognised the costs for introducing competition in the energy market for incumbents and it allowed the Government to determine, until 2010 the amount of the compensation for relevant incumbents. This article was repealed on June 23, 2006.

Example 42: Compensation for new costs

In the UK, OFGEM has allowed the costs imposed by regulatory changes to be compensated for. In relation to the RIIO Framework (see **Example 23** above) OFGEM stated: "Where the implementation of any aspect of RIIO in a single step, and in particular our financeability principles, would create financeability concerns for an efficient network company, we will put in place transition arrangements to ensure financeability. Transition arrangements include the possibility of a glide path (over one price control period). Any increase in cash flow risk will be remunerated appropriately through the allowed return."¹³⁶

Example 43: Parallel concessions

In Italy, there are examples of regulatory transitions that are accompanied by relief provisions. In March 2011 the Authority for Electric Energy and Gas introduced new sections to the Network Code (Deliberation 84/2012/R/EEL). These changes dealt, inter alia, with power plant security. Parallel concessions were introduced: the application of new rules was gradual and commensurate with the availability of the

¹³⁵ See Rules of primary legislation: including, inter alia, laws 481/95, 99/09 deliberations GOP 28/08, ARG/com 134/08, Section B of ARG/elt 191/09.

¹³⁶ See RIIO Framework, Decision Document 2011, p. 4.

technology necessary to comply with norms. If appropriately supported by documentation, firms might obtain relief from particular instances of this legislation by virtue of paragraph 14.3 of the network Code.

Example 44: Incentives

Also in the Italian energy sector (see **Example 43**), incentives have been used to encourage the embracing of new rules. Monetary awards: prizes of up to € 5'000 (minimum and provisional) were awarded to firms successfully complying with regulation, and more specifically guidance CEI 82-25, within the stipulated timeframe (before 12th June 2012). Monetary awards in lesser sums were awarded up until 31st October 2012. Conversely, punishments were not defined. The Authority merely suggested that the ultimate measure would involve cutting access to electric energy.

Flexibilities

Example 45: Flexibility on timing and technologies

In the Italian energy sector the implementation of regulatory changes in some areas has been accompanied by allowing considerable flexibility with regard to the timing and technologies used to comply with regulation. This reflected the finding that that not all firms were able to comply with the obligation of replacing meter readers within the time limit, mainly due to competitive pressures and lack of technological capability.¹³⁷

Advice Guidance and Assurance

Example 46: Technical feedback

In the Portuguese water sector the regulator has taken positive steps to help regulated firms to deal with changed rules. Thus, Decree/Law 243 of 2001 - imposed new standards of quality for water distribution. ERSAR initiated various processes to help the operators to adjust to the new quality standards. These included (i) receiving comments of market actors about the main difficulties of complying with the new standards. (ii) giving feedback on those comments (iii) giving technical feedback to the operators and permitting the use of laboratories and ERSAR consultants to clear all doubts about the application of Decree/Law 243. All these are included in the "Texts on Regulation" series #1.

Example 47: Requested opinions

In the Portuguese electricity sector a mode of offering guidance on new provisions is

¹³⁷ See Rules of primary legislation: including, inter alia, 2009/73/CE, ARG/gas 36/11 and the Minister for economic development's Decree no. 32 of 18th January 2011; Consultation documents DCO 40/11, DCO17/11; technical report SMCG_Sec0041_DC 2011-05.

the requested opinion. Under ERSE's Commercial Relationships Code in the Electricity Sector (CRCES) Art 299 - The entities that conform the SEN may ask the ERSE for a non-binding opinion regarding the interpretation of the regulation contained in the CRCES.

Example 48: On-going advice on transition

An example of a regulator managing a broad-based change by engaging in an extended process of consultation is provided by the UK Government's Department of Energy and Climate Change (DECC) in association with OFGEM. This involved the transition to smart metering from 2011 onwards and required collaboration between a Department of government and a regulatory agency.

The first public policy steps were designed by the Government's Department of Energy and Climate Change and managed on its behalf by OFGEM. From April 2011 DECC has managed the smart metering implementation process itself. Nonetheless, OFGEM is giving permanent technical advice regarding the implementation process. This technical advice includes: (i) Answering, and publishing its answers, to all DECC public consultation processes regarding the smart metering implementation; (ii) Proposing regulatory changes to licences to "ensure that domestic customers are able to switch supplier effectively if they have a meter with advanced functionality installed" and the "regulation of the early, voluntary deployment of domestic meters with smart capability by some energy suppliers"; (iii) Publishing informational documents for regulated parties and consumers regarding the smart metering implementation. ("Regulating the smart meter roll-out: how DECC's proposals for the provision of information to Ofgem might work in practice"). OFGEM's participation, and all third party responses to OFGEM driven consultations can be consulted at: ofgem.gov.uk/Markets/sm/metering/sm/Pages/ttsm.aspx. As for DECC, the programme has included: Impact Assessment process and its publication; Public Consultations about various matters referring to the smart metering implementation programme (these include data and privacy, consultations on draft licence conditions and codes of practice, engagement practices, smart energy code amongst others); Consultation Webchat and Programme Update Document. All DECC's actions regarding smart metering implementation can be consulted at: decc.gov.uk/en/content/cms/tackling/smart_meters/smart_meters.aspx.

Example 49: Advice on change management

In the UK the FSA has exemplified the strategy of advising regulated businesses on the managing of regulatory changes. In order to allow small firms and sole traders to prepare for further regulatory advances and to mitigate their regulatory risk, the FSA

delivers periodical Business Risk Awareness workshops.¹³⁸ These workshops show regulated firms what the current enforcement strategies are and allow them to make an assessment of their current compliance situation without risking sanctions.

Example 50: Assurances on prompt decision-making

A final reassurance regarding regulatory changes is offered by regulators who promise to resolve issues at an early date. Thus, in the French posts and telecommunications sector, ARCEP ensures that, in the interest of regulatory certainty, detailed terms and conditions (including tariff) implementation will be resolved expeditiously. Such matters will be given ‘plenty of visibility’ to all economic actors.¹³⁹

The above fifty examples give an idea of the ways in which different re-regulation strategies can be tailored to different circumstances. This suggests how some tentative conclusions can be drawn about the potential of the various sub-species of strategy. Table 4, accordingly, considers the special value of these sub-species in limiting costs and producing benefits in relation to a given source of change. Such a table might be offered for each source of change but one example is chosen here – that of change in primary legislation.

Table A. 16: Examples of re-regulation strategies that may be of value in addressing the costs/benefits associated with regulatory changes

Source of Change e.g. Primary legislation	Type of cost / benefit	Examples of re-regulation strategies that can be expected to be of value in addressing these cost/benefits. (Numbers below refer to the examples of strategies cited above).
	Uncertainty and capital costs	4, 5, 6, 7, 8, 9, 10, 11, 14,15, 16, 17, 18, 20, 22, 23, 24, 25, 26, 30, 31, 32, 33, 34, 35, 36, 37, 38, 39, 40, 41, 42, 46, 47, 48, 49.
	Planning costs	1, 2, 3, 4, 5, 6, 7, 8, 9, 10, 11, 12, 14, 15, 18, 19, 20, 21, 22, 23, 24, 25, 26, 28, 29, 30, 31, 32, 33, 34, 35, 36, 37, 38, 39, 41, 43, 44, 45, 46, 47, 48, 49, 50.

¹³⁸ See: www.fsa.gov.uk/smallfirms/workshops/braw/index.shtml

¹³⁹ See Decisions 2010-1312; 2009-1106.

Implementation / Transition ¹⁴⁰ and adaptive costs (e.g. retraining, using new forms) ¹⁴¹ Losses of assets that are sunk by regulatory changes.	1, 3, 4, 5, 6, 7, 8, 9.
Delays (e.g. in developing products and markets)	1, 3, 4, 24, 31, 32, 34, 41, 48.
Process costs (discussions with the regulator that are needed to adjust to new approaches).	1, 2, 3, 4, 5, 6, 9, 10, 11, 12, 13, 14, 15, 16, 17, 18, 19, 20, 21, 22, 23, 24, 25, 27, 28, 29, 30, 31, 32, 34, 36, 37, 38, 40, 41, 42, 43, 44, 45, 46, 47, 48, 49, 50.
Process benefits – where changes increase transparency, openness and accountability.	1, 2, 3, 4, 5, 6, 7, 10, 16, 19, 28, 35, 40, 43, 44, 49.
Under-inclusiveness – e.g. excess profits are uncontrolled	6, 7, 33.
Over-inclusiveness – price controls unfair or unduly constrain investment	5, 7, 13, 18, 22, 33.
Compliance cost effects – including the effects of a change on consistency with other governmental controls and incentives. ¹⁴²	1, 3, 4, 6, 7, 9, 10, 11, 12, 13, 30, 21, 22, 23, 24, 25, 30, 31, 32, 34, 36, 37, 38, 39, 41, 42, 46, 47, 48.
Effect on competition/development of new markets. Effect of regulation in either impeding or in either promoting innovation in businesses or in facilitating firms’ responsiveness to markets. ¹⁴³	2, 4, 5, 6, 7, 13, 17, 19, 20, 24, 25, 28, 32, 33, 34, 40.

¹⁴⁰ See J. Quinn and M. J. Trebilcock, Compensation, ‘Transition Costs, and Regulatory Change’ (1982) 32 *University of Toronto Law Journal* 117-175; Dorfman, *Agenda for Research on the Transitional Effects of Regulation* Report of Washington DC Conference (June 1978)

¹⁴¹ On corporate reactions to regulatory change and uncertainty see, e.g.: Christian Engau • Volker H. Hoffmann, ‘Corporate response strategies to regulatory uncertainty: evidence from uncertainty about post-Kyoto regulation’(2011) 44 *Policy Sciences* 53–80; Collis, D. (1992). ‘The strategic management of uncertainty’ (1992) 10(2). *European Management Journal* 125–135; Courtney, H., Kirkland, J., & Viguerie, P. (1997). Strategy under uncertainty. (1997) 75(6) *Harvard Business Review* 67–79; Volker H. Hoffmann Thomas Trautmann and Jens Hamprecht , ‘Regulatory Uncertainty: A Reason to Postpone Investments? Not Necessarily’ (2009) 46(7) *Journal of Management Studies*1227–1253.

¹⁴² Kivimaa, P. (2008) “The innovation effects of environmental policies: linking policies, companies and innovations in the Nordic pulp and paper industry”

¹⁴³ See BERR Economics Paper No. 4 *Regulation and innovation: evidence and policy implications* (BERR, December 2008). Department for Innovation, Universities and Skills (DIUS), *Helping Regulators to Promote Innovation* (2008). Ashford, N.A., Ayers, C. and Stone, R.F. (1985) “Using regulation to change the market for innovation” in *Harvard Environmental Law Review* Vol 9, No 2, p419-466. Businesses may innovate with respect to products but also by developing new organisational structures and business models, adopting new management practices and combining existing technologies and processes in new ways. On regulatory uncertainties and negative effects on innovation, see Marcus, A.A. (1981) “Policy uncertainty and technological



	Sanctioning costs – where failure to adjust to a change produces such effects as: exclusions from markets; monetary penalties; suspensions or bans for the business and individuals; personal liability for senior managers and compliance staff; stakeholder lawsuits; client lawsuits; remedial consulting; commitment to more resource to assist compliance; additional reporting; legal fees; and heightened scrutiny by auditors and examiners on future inspections.	28, 31, 32, 41, 43, 44, 48.
	Investment and competition effects – where uncertainties discourage entry from new operators and this reduces competition and consumer welfare.	1, 3, 4, 5, 6, 7, 9, 11, 12, 13, 14, 22, 23, 24, 25, 29, 31, 32, 33, 34, 41, 42, 43, 44, 45, 47, 48, 50.

innovation” in *Academy of Management Review* Vol 6, No 3, pp 443-448. On regulatory lag and costs see: P.L. Joskow, D. R. Bohi and F. M. Gollop ‘Regulatory Failure, Regulatory Reform, and Structural Change in the Electrical Power Industry’ (1989) *Brookings Papers on Economic Activity. Microeconomics* 125-208.

Appendix 2 - Competition law as an adjunct or obstacle to regulatory certainty: the energy sector as a case study

This appendix focuses on the impact of remedies imposed under the European Union Merger Regulation (“EUMR”) and competition law regimes on the principle of regulatory certainty in the energy sector in the European Union (EU).

Overview of EU energy legislation

The liberalisation of energy markets is considered to be one of the cornerstones of the EU energy policy.¹⁴⁴ To this end, the EU started opening up those markets to competition in the 1990s by *inter alia* slowly abandoning the model of vertically integrated State-owned companies. The first liberalisation package was adopted in 1996 and in 1998.¹⁴⁵ However, in light of the rather limited results achieved, partially due to the opposition by the EU Member States, this first regulatory package was replaced by a second package in 2003,¹⁴⁶ which included unbundling provisions that required transmission networks to be run independently from the production and supply functions. Moreover, the second regulatory package established deadlines for the market openings for household and non-household consumers.

The Energy Sector Enquiry and the 3rd Energy Package

Despite the implementation of two separate sets of liberalisation, the goal of a competitive and well-functioning European energy market was not achieved despite the full market opening scheduled for 2007.¹⁴⁷ In its Sectorial Inquiry launched pursuant to Article 17 of Regulation (EC) No 1/2003 into the European gas and electricity sectors,¹⁴⁸ the Commission concluded that consumers and businesses were being harmed because of inefficient and expensive gas and electricity markets. In particular, the Commission identified market failures in relation to: (a) high levels of market concentration; (b) vertical integration; (c) lack of market integration; (d) lack of transparency; (e) ineffective price formation; (f) limited competition at the retail level; (g) balancing markets favouring the incumbents; and (h) underdeveloped

¹⁴⁴ This section and the next amplify Section 2.2 above.

¹⁴⁵ See Directive 96/92/EC of the European Parliament and of the Council of 19 December 1996 concerning common rules for the internal market in electricity (OJ L 27, 30.1.1997, p. 20–29), and Directive 98/30/EC of the European Parliament and of the Council of 22 June 1998 concerning common rules for the internal market in natural gas (OJ L 204, 21.7.1998, p. 1–12).

¹⁴⁶ See Directive (EC) 2003/54/EC of the European Parliament and of the Council of 26 June 2003 concerning common rules for the internal market in electricity and repealing Directive 96/92/EC (OJ L 176, 15.7.2003, p. 37), and Directive 2003/55/EC of the European Parliament and of the Council of 26 June 2003 concerning common rules for the internal market in natural gas and repealing Directive 98/30/EC (OJ L 176, 15.7.2003, p. 57).

¹⁴⁷ See N. Kroes Speech: “Introductory remarks on Final Report of Energy Sector Competition Inquiry” of 10 January 2007 (SPEECH/07/4).

¹⁴⁸ See the Final Report of 10 January 2007 (COM(2006)851 final).

LNG markets.¹⁴⁹

The adoption of the Third Energy Package,¹⁵⁰ which included more stringent rules on the unbundling of networks, was the legislative response to these identified shortcomings. Moreover, taking into account the political opposition to ownership unbundling,¹⁵¹ the Commission supplemented the slow-paced energy liberalisation process with merger control (“EUMR”)¹⁵² as well as its more general competition powers.¹⁵³

Use of Remedies in the Energy Sector

The Commission has sought to achieve its goal of integration of energy markets,¹⁵⁴ in both merger and competition cases, through the use of various remedies, generally classified as either structural or behavioural. The former literally change the “structure” of the affected markets, most notably through divestitures,¹⁵⁵ while the latter impose certain obligations as to conduct on the dominant market players – for

¹⁴⁹ See the Final Report, at paras. 997-1020.

¹⁵⁰ See, in particular, Directive 2009/72/EC of the European Parliament and of the Council of 13 July 2009 concerning common rules for the internal market in electricity and repealing Directive 2003/54/EC (OJ L 211, 14.8.2009, p. 55–93, hereinafter the “Electricity Directive”) and Directive 2009/73/EC of the European Parliament and of the Council of 13 July 2009 concerning common rules for the internal market in natural gas and repealing Directive 2003/55/EC (OJ L 211, 14.8.2009, p. 94–136, hereinafter the “Gas Directive”).

¹⁵¹ To the point that, in parallel with adopting the third package, the Commission sent letters of formal notice to proceedings against a number of Member States for 25 Member States for not complying with the second package; see “Commission acts to ensure effective and competitive energy market across Europe”, IP/09/1035 of 25 June 2009. Furthermore, the third package is seen to be “watered down” as the Member States were allowed to choose alternative solutions to ownership unbundling which was the Commission’s initial intention; see Velasco Fernandez J., “Electricity merger control in the light of the EU “Third energy package”” (2010), *Cornell Law School Inter-University Graduate Student Conference Papers*, Paper 41, at p. 4. It must also be noted that the third package provides for certain caveats to ownership unbundling, such as the possibility to assign different functions, *i.e.* generation and supply, on the one hand, and transmission on the other, to two different public bodies.

¹⁵² See Council Regulation (EC) No 139/2004 of 20 January 2004 on the control of concentrations between undertakings (the “Merger Regulation”, OJ L 24, 29.01.2004, p. 1-22). See also “The liberalisation of EU Energy Markets”, Director-General Philip Lowe’s speech in London, The Beesley Lectures, Institute of Economic Affairs, 09.11.2006; and Velasco Fernandez J., “Electricity merger control in the light of the EU “Third energy package””, at p. 17: “Thus, the test applied to review concentrations in the electricity industry will not require a substantially different procedure from the one undertaken when reviewing concentrations in other fields, but just a framework flexible enough to accommodate the specific features of the electricity markets”.

¹⁵³ See Council Regulation (EC) No 1/2003 of 16 December 2002 on the implementation of the rules on competition laid down in Articles 81 and 82 of the Treaty (“Regulation 1/2003”, OJ L 1, 04.01.2003, p.1-25). See also, *inter alia*, “Antitrust: Commission confirms unannounced inspections in the natural gas sector”, Commission Press Release of 27 September 2011 (MEMO/11/641). On the other hand, the Commission is hesitant to admit that the exercise of its antitrust powers is inspired by its Sector Enquiry; see Koch O., Nagy K., Pucinskaite-Kubik I., and Tretton W., “The RWE gas foreclosure case: Another energy network divestiture to address foreclosure concerns”, *Competition Policy Newsletter 2-2009*, at p. 34.

¹⁵⁴ See, *inter alia*, N. Kroes Speech: “The need for a renewed European energy policy” (OFGEM seminar on Powering the Energy Debate: Europe - Competition and Regulation) of 28 September 2006 (SPEECH/06/541).

¹⁵⁵ Other structural remedies are, for example, granting access to key infrastructure or inputs on non-discriminatory terms. See Commission Notice on remedies acceptable under the Council Regulation (EC) No 139/2004 and under Commission Regulation (EC) No 802/2004 (OJ C 267, 22.10.2008, p. 1-27), at para. 17.

example by preventing them from increasing prices.¹⁵⁶ In other words, “*Structural remedies are like surgeries, eliminating extreme market power with one slash and requiring much less close scrutiny vis-à-vis behavioural remedies like medicines targeting a specific competitive problem and needing constant supervision*”.¹⁵⁷ Though structural remedies present their own problems, such as the necessity to find a suitable potential purchaser and the need to establish the viability of the carved-out business to be autonomously operated on a long-term basis, the Commission has a clear preference for this type of measure, because *inter alia*, they require much lower levels of monitoring than their behavioural counterparts.¹⁵⁸

Merger remedies

To illustrate this by recourse to the early merger decisions, in Case No IV/M.931 – *Neste/IVO*¹⁵⁹ Neste had, through its majority controlled subsidiary Gasum Oy, a *de facto* monopoly in the supply of natural gas in Finland. This monopoly, given the lack of links with foreign transmission systems, derogations from the main provisions of the first package and the importance of natural gas for electricity generation, led the Commission to demanding an effective carve-out of Gasum Oy from the merged entity. By contrast, confronted with a prospect of a significant duopoly in Germany in the market for the supply of electricity from the interconnected grid in Case COMP/M.1673 – *VEBA/VIAG*,¹⁶⁰ the Commission required both companies to carve out a significant part of their business located in Eastern Germany, VEAG, and to buy electricity from it for a period of seven years. In addition, the companies agreed to change their rules of electricity transmission.

In reviewing these cases, one commentator has argued that “[t]he Commission has

¹⁵⁶ Note that behavioural remedies are accepted by the Commission “*only exceptionally in very specific circumstances*” (ibid.) and they need to be carefully tailored to address the relevant competition concerns.

¹⁵⁷ Wang W., “Structural Remedies in EU Antitrust and Merger Control”, *World Competition* 34, no. 4 (2011), at p. 588. Accordingly, this paper will focus on structural remedies to support its argumentation.

¹⁵⁸ Velasco Fernandez J., “Electricity merger control in the light of the EU “Third energy package””, at pp. 68-70.

¹⁵⁹ Decision of 14 July 1998.

¹⁶⁰ Decision of 13 June 2000. See also the following selection of cases for an overview of divestitures imposed by the Commission in the EUMR decisions: Case IV/M.1383 – *Exxon/Mobil* (Decision of 29 September 1999); Case IV/M.1532 *BP Amoco/Arco* (Decision of 29 September 1999); Case COMP/M.1853 – *EDF/EnBW* (Decision of 7 February 2001) which included electricity auctions; Case COMP/M.2822 – *EnBW/ENI/GVS* (Decision of 17 December 2002) which included termination rights for long-term contracts; Case COMP/M.2947 – *Verbund/EnergieAllianz* (Decision of 11 June 2003); Case COMP/M.3410 – *Total/Gaz de France* (Decision of 7 January 2005); Case COMP/M.3696 – *E.ON/MOL* (Decision of 21 December 2005); Case COMP/M.3868 – *DONG/Elsam/Energi E2* (Decision of 14 March 2006); Case COMP/M.4110 – *E.ON/Endesa* (Decision of 16 May 2006); Case COMP/M.4180 – *Gaz de France/Suez* (Decision of 14 November 2006); Case COMP/M.5496 – *Vattenfall/Nuon Energy* (Decision of 22 June 2009); Case COMP/M.5467 – *RWE/Essent* (Decision of 23 June 2009) which included divestitures of electricity trademarks; Case COMP/M.5549 – *EDF/Segebel* (Decision of 12 November 2009) which included divestitures of Combined Cycle Gas Turbines (“CCGTs”) in order to, *inter alia*, incentivise the merging parties to keep investing in this technology; and Case COMP/M.5978 – *GDF Suez/International Power* (Decision of 26 January 2011).

tended to adopt a strict approach to the evaluation of [the competition] effects, and consideration of the relevant remedies, in light of the incipient nature of deregulation in some of the national markets affected by the mergers, and specific features of energy markets which may exacerbate market power and merger effects”.¹⁶¹ The General Court (then the Court of First Instance) subsequently backed the Commission’s review of mergers in the energy sector in the *EDP/Commission case*¹⁶² which upheld a prohibition decision in Case COMP/M.3440 – *ENI/EDP/GDP*.¹⁶³ Thus, where the commitments are accepted, the merging parties benefit from procedural economy and speed which allow them to carry out strategic investments within a reasonable timeframe. On the other hand, the Commission can pursue a market opening strategy where the legislature has failed to do so, by accepting undertakings from the parties which are, “in theory (emphasis added) ... suitable, necessary and proportional to the underlying competition law problem”.¹⁶⁴

Antitrust remedies

A competition decision accompanied by remedies can be adopted pursuant to either Article 7 or Article 9 of Regulation 1/2003. There are several fundamental differences between the two provisions, including:

- a) the remedies under Article 7 are imposed by the Commission on its own initiative pursuant to a standard infringement procedure.¹⁶⁵ By contrast, Article 9 remedies are offered by the undertakings in question on their own initiative, and the Commission is free to decide whether or not to accept them.¹⁶⁶

¹⁶¹ Giulio F., “The Competition Effects of Energy Mergers: Economic Analysis in Europe and in Spain”, IESE Business School – University of Navarra, *Occasional Paper 185* (February 2011), at p. 10. By contrast, see Recital 30 of the Merger Regulation which mentions the proportionality criterion. This key aspect of the remedial practice shall be discussed in the following sections.

¹⁶² Case T-87/05 EDP – *Energias de Portugal, SA v Commission of the European Communities* [2005] ECR II-03745.

¹⁶³ Decision of 9 December 2004.

¹⁶⁴ Hancher L. and de Hauteclocque A., “Manufacturing the EU Energy Markets: The Current Dynamics of Regulatory Practice”, *EUI Working Paper* (RSCAS 2010/01), at p. 9. On the principle of proportionality in the EUMR setting, see also Case C-202/06 P *Cementbouw Handel & Industrie BV v Commission of the European Communities* [2007] ECR I-12129, at para. 53, confirming the Commission’s wide “*discretionary margin implicit in the provisions of an economic nature which form part of the rules on concentrations*”. Furthermore, pursuant to para. 54 of the judgment, the Commission must be “*satisfied that those conditions and those obligations are proportionate to and would entirely eliminate the competition problem that has been identified.*” While the case was ruled under the old Council Regulation (EEC) No 4064/89 of 21 December 1989 on the control of concentrations between undertakings (OJ 1989 L 395 p. 1, and corrigendum OJ 1990 L 257, p. 13), as amended by Council Regulation (EC) No 1310/97 of 30 June 1997 (OJ 1997 L 180, p. 1), Case T-342/07 *Ryanair Holdings plc v European Commission* [2010] ECR II-03457, at para. 29, demonstrates that the principle has remained unchanged.

¹⁶⁵ Wang W., “Structural Remedies in EU Antitrust and Merger Control”, at p. 585; and Sadowska M., “Energy Liberalization in Antitrust Straitjacket: A Plant Too Far?”, *EUI Working Paper* (RSCAS 2011/34), at p. 3.

¹⁶⁶ Should the Commission accept them, such remedies become legally binding on the undertaking in question. The Commission subsequently closes the case. Article 9 remedies are thus called ‘commitments’; see “Antitrust: Commission’s commitment decision opens German gas pipelines to competitors – frequently asked questions”, Commission Press Release of 4 May 2010 (MEMO/10/164).

in order to impose remedies under Article 7, the Commission must first find that an infringement of competition rules had occurred, support it with sufficient evidence, and explain how the remedies would address the unlawful behaviour at issue. On the other hand, pursuant to Article 9, none of the elements of unlawful behaviour¹⁶⁷ need to be demonstrated. Therefore, *“a decision under Article 9 does not conclude whether or not there has been an infringement, and the appropriateness of the remedies is assessed in light of the concerns expressed in the Commission’s preliminary assessment”*.¹⁶⁸

unlike Article 7 decisions in which the Commission may simultaneously impose remedies and fines, Article 9 decisions do not involve an imposition of fines since, as highlighted above, there is no finding of infringement on the first place.¹⁶⁹ In practice, this means that every undertaking needs to carry out its own cost-benefit assessment (*i.e.*, whether and how far-reaching remedies it should offer in the light of the amount of fines it might have to pay should a full infringement decision be adopted).

Article 7 makes an express reference to the principle of proportionality, whereas the situation under Article 9 is slightly more obscure, particularly because the European Court of Justice has rejected the notion that Article 7 should be the reference point for the proportionality of commitments under Article 9 decisions in its *Alrosa* judgment.¹⁷⁰ The Court held that Article 7 remedies must be *“proportionate to the infringement committed and necessary to bring the infringement effectively to and end”*.¹⁷¹ By contrast, under Article 9, the Commission’s duty in relation to the principle of proportionality *“is confined to verifying that the commitments in question address the concerns it expressed to the undertakings concerned and that they have not offered less onerous commitments that also address those concerns adequately”*.¹⁷² Finally, the Court confirmed that, under Article 9, the Commission has a wide discretion as to whether to accept or reject the undertaking’s commitments.¹⁷³ Thus, the Commission enjoys a considerably wider discretion in its remedial practice under Article 9 of Regulation 1/2003 in comparison to the EUMR.

¹⁶⁷ Such as the existence of abuse or even dominance under Article 102 TFEU.

¹⁶⁸ Wang W., “Structural Remedies in EU Antitrust and Merger Control”, at p. 586.

¹⁶⁹ *Ibid.* The exceptions to this rule are the instances where the undertaking in question breaches any of its commitments. See, to this effect, “Antitrust: Commission opens proceedings against Microsoft to investigate possible non-compliance with browser choice commitments”, Commission Press Release of 17 July 2012 (IP/12/800); and J. Almunia’s Speech: “Statement on Microsoft non-compliance with the browser choice commitments” of 17 July 2012 (SPEECH/12/561).

¹⁷⁰ Case C-441/07 P *European Commission v Alrosa Company Ltd.* [2010] ECR I-05949, at para. 45.

¹⁷¹ *Ibid.*, at para. 39.

¹⁷² *Ibid.*, at para. 41.

¹⁷³ *Ibid.*, at para. 94.

While Article 7(1) expressly states that structural remedies can only be imposed either where there is no equally effective behavioural remedy or where any equally effective behavioural remedy would be more burdensome for the undertaking concerned than the structural remedy, there is no similar provision under Article 9. Therefore, under Article 7, where structural remedies would appear to be of a rather ancillary, if not of an exceptional nature, with Article 9 offering both the Commission and the undertaking concerned much more bargaining freedom.¹⁷⁴

Observations (a) – (e) above arguably explain why, thus far, all structural remedies in competition cases have been accepted under Article 9 of Regulation 1/2003.¹⁷⁵ The first examples of a Commission Decision where structural remedies were adopted in an energy sector competition investigation in the EU are found in Cases COMP/39.388 – *German Electricity Wholesale Market* and COMP/39.389 – *German Electricity Balancing Market*,¹⁷⁶ where the Commission accepted E.ON's proposal to divest its power plants and transmission network. The commitments were said to address two particular "theories of harm":

First, that E.ON may have designed a strategy to withdraw available generation capacity with a view to raising electricity prices to the detriment of consumers.

Second, that E.ON may have abused its dominant position on the market for balancing reserves by increasing its own costs with a view to favouring its production affiliate and by passing those costs on to the final consumer, and by preventing power producers from other Member States from exporting balancing energy into the E.ON balancing market.

The next three decisions addressed gas foreclosure concerns. First, in Case COMP/39.402 – *RWE Gas Foreclosure*,¹⁷⁷ the Commission was concerned that RWE may have abused its dominant position by refusing access to its network and by setting its transmission tariffs at a level causing a margin squeeze. To address the Commission's concerns, RWE committed to divest its existing high-pressure gas transmission network, including the necessary personnel and ancillary assets and services. Second, in Case COMP/39.317 – *E.ON Gas*,¹⁷⁸ the Commission's main concern was that E.ON may have closed off competitors from the market by booking almost the entire capacity at key entry points into the gas network on a long-term

¹⁷⁴ Wang W., "Structural Remedies in EU Antitrust and Merger Control", at p. 587, 592-593.

¹⁷⁵ Consequently, all the remaining references to antitrust decisions in this paper relate to proceedings closed pursuant to Article 9 of Regulation 1/2003, in particular to those which led to structural remedies outlined in this section.

¹⁷⁶ Decision of 26 November 2008.

¹⁷⁷ Decision of 18 March 2009.

¹⁷⁸ Decision of 4 May 2010.

basis. Subsequently, E.ON undertook to release large capacity volumes at the entry points to its gas networks immediately following the Decision, and to further reduce its bookings of entry capacity from October 2015. Third, in Case COMP/39.315 – *ENI*,¹⁷⁹ the Commission’s preliminary view was that ENI was refusing access to capacity available on its network and strategically limiting investment in ENI’s international transmission pipeline system. To avoid fines, ENI agreed to divest its shares in three international transport pipelines to Italy.

Two points arise from these precedents. First, whether by way of any direct or indirect link with the Sectoral Enquiry, these examples leave no doubt that the Commission has used its competition powers, in addition to those under the EUMR, to foster market liberalisation through the imposition of ownership unbundling obligations. Second, it has done so in a novel manner – referred to as ‘negotiated’ antitrust by some,¹⁸⁰ whereby the quality of remedies it achieves is proportionate to the bargaining position of the undertaking addressed by its particular decision. This bargaining process is said to go far beyond the circumstances of the case at issue. More specifically, the common feature of the Decisions resulting in structural remedies outlined above was that each of those companies was facing two or more competition investigations simultaneously.¹⁸¹ Consequently, commitments offered under the Article 9 process could be seen to be a sign of goodwill of a company concerned by the imposition of substantial and imminent antitrust fines or, more pragmatically, as a way to cut its losses by recourse to a settlement procedure.

Issues arising from remedies in the energy sector

A number of criticisms have been raised in relation to the Commission’s practices under both the EUMR and the competition fields in this sector, primarily revolving around the notion of forced ‘backdoor unbundling’.¹⁸² It is also now widely accepted that issues such as security of supply, electricity and natural gas prices and CO2 emissions are readily included the Commission’s competition assessments.¹⁸³ The question is, however, the extent to which then the application of those principles in the energy sector distorts market outcomes, whether through ‘primary’ or ‘residual’ effects.

In terms of the primary effects of remedies under the EUMR and competition

¹⁷⁹ Decision of 29 September 2010.

¹⁸⁰ Sadowska M., “Energy Liberalization in Antitrust Straitjacket: A Plant Too Far?”, at p. 17.

¹⁸¹ Wang W., “Structural Remedies in EU Antitrust and Merger Control”, at p. 584.

¹⁸² For the origin of the term see, *inter alia*, Von Rosenberg H., “Unbundling through the Back Door...the case of network divestiture as a remedy in the energy sector”, *European Competition Law Review*, Volume 30, Issue 5, 2009, at pp. 237-254.

¹⁸³ For a useful discussion with relation to the EUMR, see *inter alia* Velasco Fernandez J., “Electricity merger control in the light of the EU “Third energy package””, at pp. 74-86.

investigations on the principle of regulatory certainty, the answer also depends on whether the term ‘regulation’ only refers to formal legislative measures. If that is the case, it is fair to say that stakeholders cannot assess the situation in the market by recourse to legislation alone and, therefore, their certainty regarding market circumstances is undermined. However, this paradigm has always been present in many different sectors, not just in energy.¹⁸⁴

This response would be no different if the EUMR were to be characterised as a regulatory measure in its own right due to its *ex ante* character or, even further, if the subject of regulatory certainty was stretched to cover all aspects of legal certainty so as to encompass the Commission’s competition powers. In this latter respect, the discussion invariably revolves around the legitimacy of including non-competition concerns in the competition law and EUMR assessments.¹⁸⁵ While the EUMR makes an express reference to the possibility of inclusion of such additional considerations,¹⁸⁶ Regulation 1/2003 is silent on the issue. Finally, the existence of the legal basis for the inclusion of such additional principles and the arguments for and against their inclusion do not contribute towards their quantification.¹⁸⁷

The aim of the discussion below will be to identify the residual effects, namely, the main pitfalls in the in the EUMR and competition practices respectively, which could lead to a blurring of regulatory goals (and hence impede the principle of regulatory certainty). In other words, the focus shall be on those aspects of the Commission’s practices which do not produce satisfactory results, either because of their lack of conformity with the economic principles or legal norms accepted in the EU, and which therefore undermine regulatory certainty upon which the various stakeholders could otherwise rely.

¹⁸⁴ Though, given the scope of the divestitures and the extent to which they affect the market, the energy sector is particularly ripe for these discussions.

¹⁸⁵ See *inter alia* Velasco Fernandez J., “Electricity merger control in the light of the EU “Third energy package””, at pp. 84-86. The author concludes that “drawing the line between the reasonable elements that a competition authority could incorporate to its analysis and the excessive discretionary power that would be granted to the European Commission as a result of the inclusion of multiple items of evidence upon which take a merger decision (that, at the end, might endanger the legal certainty and necessary predictability when proposing merger operations) is not obvious. (...) The elaboration of mandatory but not binding reports on these non-competition aspects by other divisions within the European Commission (...) could also be part of a solution, avoiding the adulteration of the competition analysis carried out by that DG Competition.”

¹⁸⁶ See Article 21(4).

¹⁸⁷ In relation to the commitments pursuant to antitrust investigations, see Willis P., and Hughes P., “Structural Remedies in Article 82 Energy Cases”, *The Competition Law Review*, Volume 4 Issue 2 (July 2008), at pp. 168-173, where the authors test the Commission’s limits on the power to order structural remedies against the principles of proportionality, subsidiarity, human rights and Article 295. They arrive at a generally positive conclusion. However, the broad character of these principles makes them only really applicable in situations of their flagrant breach by the Commission. Furthermore, they are, by their very nature, unquantifiable (with the only possible exception of proportionality which will be discussed below).

The design of remedies is identified as the most controversial aspect of the EUMR in the energy sector, particularly due to the Commission's almost exclusive reliance on structural divestitures¹⁸⁸ in order to address its competition concerns, which often effectively re-align the competitive structure on the relevant market and beyond.¹⁸⁹ Whether the merger control process is well-suited to achieve these results is questionable, given the high degree of uncertainty, speculation and asymmetries of information inherent in the assessment, particularly at the remedial stage.¹⁹⁰ It has thus been argued that, since the Commission's practices amount to a deliberate design of market structures at its own discretion, this effectively amounts to interventions traditionally termed 'industrial policy', which ought in principle to be considered as *ultra vires*.¹⁹¹

The economic literature also criticises the Commission's remedial practices for being inherently biased, with a number of identifiable circumstances where the parties' offers have been disproportionate in relation to the anticipated competitive harm at issue.¹⁹² Had it not been for the Commission's clearly superior bargaining position in remedies negotiations,¹⁹³ this outcome could be viewed as being extremely counter-intuitive given the parties' advantage in possessing exclusive access to most of the relevant information in relation to the nature and scope of the remedies offered. Moreover, the literature presents models indicating potentially beneficial mergers which might be abandoned or undermined due to the provision of disproportionate remedies.¹⁹⁴

Finally, even assuming that the Commission does not err in its assessment, and the argument that it is entitled to use its EUMR powers effectively in a regulatory manner is accepted, problems regarding the asymmetry of information and the

¹⁸⁸ Interestingly, the US Federal Energy Regulatory Commission appears to be relying primarily on behavioural remedies; see Velasco Fernandez J., "Electricity merger control in the light of the EU "Third energy package"", at p. 35, in particular the study presented in footnote 92.

¹⁸⁹ *Ibid.*, at p. 9.

¹⁹⁰ Christiansen A., "Regulation and EU Merger Control in the liberalised electricity sector", Philips-University of Marburg, at p. 13. See also INFER Workshop on "Competition Policy in Network Industries", London – October 31, 2005.

¹⁹¹ *Ibid.*, at p. 14. See also the author's criticism of the early decisions in VEBA/VIAG and Verbund/EnergieAllianz. He argues, at p. 15, that "the two case studies suggest that the Commission took the wrong decision in allowing the mergers in modified form. With the benefit of hindsight, they appear to have been "non-remediable" cases, which consequently should have been prohibited. This effectively calls for a tough(er) merger control regime in the liberalised electricity sector".

¹⁹² Lyons B., and Medvedev A., "Bargaining over Remedies in Merger Regulation", *CCP Working Paper 07-3*, February 2007, at p. 20. Note that this is in stark contrast with the Commission's acknowledgement that mergers in the energy sector can bring about substantial consumer benefits; see "Strategy Paper – Medium Term Vision for the Internal Electricity Market", *DG Energy and Transport Working Paper*, 1 March 2004, at p. 16.

¹⁹³ Particularly during the in-depth phase II investigation; see Velasco Fernandez J., "Electricity merger control in the light of the EU "Third energy package"", at p. 67.

¹⁹⁴ *Ibid.*, at p. 9.

parties' incentives arise. The merging parties will always be incentivised to offer 'back-handed' remedies which appear to address the competition issues identified by the Commission, but which in reality fall short of ensuring that competitors can continue to compete vigorously. For example, the merging parties may prefer a certain buyer over another, who might be much less "appropriate" than what is prescribed in the Commission's *Remedies Notice*.¹⁹⁵ It is also possible that the parties might also attempt to undermine the divested business by withdrawing the key personnel or business know-how.¹⁹⁶

Competition remedies – specific issues

It must be noted at the outset that the considerations outlined in the EUMR-specific discussion above also apply in relation to the commitments made in the context of competition law investigations. Thus, it is appropriate to focus on the pitfalls identified in the particular cases in the application of Article 9 settlements under Regulation 1/2003, including the criticisms voiced in relation to the general character of this provision.

Due to the inherent lack of transparency in Article 9 decisions, the issue of the proportionality of the measures becomes less of an issue of economic appraisal than in the case in the EUMR cases.¹⁹⁷ By contrast, it largely hinges on the matter of legal principle, *i.e.* whether and to what extent structural remedies can be imposed in the absence of a full Decision being adopted.

To this end, the Judgment of the European Court of Justice in *Alrosa* made it clear that the principle of proportionality is applied in a relatively unrestricted manner in the context of commitment Decisions, partially in order to safeguard principles of procedural efficiency.¹⁹⁸ However, there are several disadvantages to this solution,

¹⁹⁵ See Commission Notice on remedies acceptable under the Council Regulation (EC) No 139/2004 and under Commission Regulation (EC) No 802/2004 (OJ C 267, 22.10.2008, p. 1-27), at paras. 48-52.

¹⁹⁶ Christiansen A., "Regulation and EU Merger Control in the liberalised electricity sector", at p. 14.

¹⁹⁷ Nevertheless, some reservations as to the substance of such commitments have been voiced; see Hancher L. and de Hauteclocque A., "Manufacturing the EU Energy Markets: The Current Dynamics of Regulatory Practice", at pp. 11-12, in relation to the appropriateness of forced auctions and the balancing of short and long-term efficiency goals, such as entry and investment. Some authors have been particularly analytical in their assessment of the commitments; see Sadowska M., "Energy Liberalization in Antitrust Straitjacket: A Plant Too Far?", at p. 17: "(...) it is highly questionable whether the divestment of power plants representing a cross-section of E.ON's generation portfolio is the best-suited remedy for a strategic capacity withdrawal. Nonetheless, the accumulation of anticompetitive concerns in the preliminary assessment, which went beyond the alleged capacity withdrawal abuse, allowed the Commission first to recourse to a structural solution disregarding alternative behavioural remedies and then to justify an across-the-board divestiture, reducing E.ON's market share in absolute terms. The ultimate shape of the commitment package was thus a result of negotiations between the Commission, pursuing a goal of energy market liberalization, and E.ON, acting in its own strategic interest".

¹⁹⁸ Sadowska M., "Energy Liberalization in Antitrust Straitjacket: A Plant Too Far?", at p. 9. Other benefits cited are responsive regulation and restorative justice; see Cengiz F., "*Alrosa v. Commission* and *Commission v. Alrosa*: Rule of Law in Post-Modernisation EU Competition Law Regime", *TILEC Discussion Paper*, September 2010 (DP

which could be broadly grouped in the following way:

Unpredictability

It has been noted that, “[i]f restructuring is increasingly completed through ex post interventions, based on individual cases, and sometimes leading to semi-structural measures, it creates an unpredictable regulatory framework for other players in the market. Legal certainty and more generally the clarification of rules is a particularly important goal of regulation in newly liberalized markets as it facilitates both the entry of new competitors who already suffer from asymmetries of information and investment in some high fixed-cost technologies necessary for long-term security of supply. Legal certainty thus has a positive impact both on short and long-term efficiency criteria. Lastly, the deterrence potential of the antitrust laws is largely associated with the predictability of enforcement, and this predictability may itself be correlated with its simplicity.”¹⁹⁹

Thus, given their very nature, Article 9 commitments only contribute to the creation of this aura of unpredictability and lack of transparency. They are also susceptible to being significantly altered by third party comments, which are submitted pursuant to those parties’ own private agendas.²⁰⁰ They have no precedent-building power which could be later invoked and relied upon. It is impossible to unequivocally assess whether they satisfy the principle of proportionality or, at the very least, the rule of reason.²⁰¹ This appears to be the inevitable consequence of allowing the level of discretion to the Commission that has been approved by the European Court of Justice in the appeal in *Alrosa*. The eventual outcome, as it has been commented upon, is an “on-going process of ‘trial-and-error’ which hardly clarifies the new rules of the game in the liberalized market context.”²⁰² *Recommendations*

Legitimacy

The Article 9 commitment procedure also raises the problem raised earlier of political legitimacy and accountability. Since the Commission can extract structural divestitures from the parties, this allows it to accomplish policy goals which it would not otherwise be able to extract due to the opposition from the Member State level. In particular, it can impose ownership unbundling by *ex post* means when it is

2010-033).

¹⁹⁹ Hancher L. and de Hauteclocque A., “Manufacturing the EU Energy Markets: The Current Dynamics of Regulatory Practice”, at p. 12.

²⁰⁰ Cengiz F., “*Alrosa v. Commission* and *Commission v. Alrosa*: Rule of Law in Post-Modernisation EU Competition Law Regime”, at p. 7.

²⁰¹ Not necessarily due to the Commission’s market liberalisation agenda, but rather due to the sheer complexity of the cases.

²⁰² Hancher L. and de Hauteclocque A., “Manufacturing the EU Energy Markets: The Current Dynamics of Regulatory Practice”, at p. 13.

impossible to do so through *ex ante* regulation.²⁰³ While such an approach arguably brings with it certain long-term welfare gains, it also leads to market-reshuffling beyond the limits prescribed by the national regulatory frameworks.

This tendency needs to be seen in the context of over-enforcement, which is the outcome of the Commission's superior bargaining position solidified by its investigative and enforcement powers. For example, should it not be satisfied with the outcome of the Article 9 proceedings, it has the option to proceed to adopt a final decision and impose a heavy fine.²⁰⁴

Judicial Review

Aside from the Commission's considerable margin of discretion available to it in its substantive assessment in general, and in Article 9 proceedings in particular, a commitment Decision allows it to practically insulate itself from the review of the European Courts. In other words, Article 9 Decisions are virtually immune to effective judicial review. A claimant would need to prove that there was a manifest error in the Commission's preliminary concerns presented to them, or that any of the negotiations carried out behind closed doors led to a serious procedural injustice.²⁰⁵

Summary

While we can stop short of concluding that the EUMR and competition rules have been "*bent and stretched beyond their proper limits [and] slip out of their own systemic framework*",²⁰⁶ it is nevertheless the case that the legal certainty to which *ex ante* regulatory measures aspire is undermined by the mechanics of enforcement of merger review decisions and competition law infringement actions, especially as regards the negotiation of remedies. At the time of writing, however, the Commission is considering the very question of "harmonizing" remedies across different legal instruments across the competition law regulatory divide. Insofar as such a policy is adopted, the current legal certainty concerns discussed above might be reduced.

²⁰³ Ibid.

²⁰⁴ Wils W., "Efficiency and Justice in European Antitrust Enforcement", Oxford: Hart Publishing 2008, at p.11.

²⁰⁵ For the discussion on the judicial review problem in the presence of administrative discretion, see Cengiz F., "*Alrosa v. Commission* and *Commission v. Alrosa*: Rule of Law in Post-Modernisation EU Competition Law Regime", at pp. 13-15.

²⁰⁶ Sadowska M., "Energy Liberalization in Antitrust Straitjacket: A Plant Too Far?", at p. 18