

Contribution to the Commission consultation

COMMUNITY GUIDELINES FOR THE APPLICATION OF STATE AIDS RULES IN RELATION TO RAPID DEPLOYMENT OF BROADBAND

General Comments

Telefónica supports and welcomes the effort made by the European Commission to clarify and delimit the framework for public investment in our sector in the EU. Telefónica also welcomes the opportunity given by the Commission's to comment on the application of state aid rules for next generation networks. Our experience is that regulatory uncertainty is the major hurdle for (private) investment in next generation networks. We have the hope that these Guidelines, with some improvements that we suggest throughout this paper will contribute to a more transparent situation that will allow operators to make informed investment decisions.

Nevertheless, it is necessary to stress that the issue of promoting the deployment of new generation networks through state aids must be analysed taking also into account the regulatory framework applicable to NGAs. This matter needs a global approach and it is important to clarify the effects of applying measures from both subsidising and regulatory frameworks. We stress that these draft Guidelines must be fully in line with other recommendations and texts regarding NGAs of the Commission. Telefónica believes that the Commission should in first place create the right conditions for operators to invest in NGAs, thus lessening the possible need for state aid. State aids are a measure of last resort. It would be counterproductive if these Guidelines would try to remedy an issue caused by another piece of Community legislation, namely inadequate incentives for NGA investments.

Telefónica believes that the draft of the Commission contains many positive aspects, and taken as a whole we believe it is a good starting point to come to a set of Guidelines that can foster investment and contribute to the objective of "broadband for all". Telefónica commends the Commission for such a timely consultation.

The issue of state aids for broadband is not new. In the recent past the Commission has taken several decisions on this issue, in particular in response to requests from Member States regarding subvention of broadband roll-out in rural areas. With a number of exceptions Telefónica agrees with the way Commission

assessed these state aid cases. As the draft Guidelines are to a large degree a continuation of these decisions, we also feel comfortable with the general thrust and reasoning in this paper.

However, compared to the state aid cases for rural broadband the draft Guidelines contemplate the issue of state aid in a far more complex environment. Government support for NGA roll-out will take place in a market where there is already a substantial level of service provision through copper based broadband networks. State aids are likely to impact and distort that existing market. At least as important is the likely impact state aid will have on other private NGA investment.

This constitutes a big shift from the traditional approach: use of state aids to bridge the “digital divide”. Instead of this, they will be allowed in order to accelerate the deployment of NGAs. If state aids are used to accelerate the deployment of NGAs, it will be impossible to know what the role of the market would have been. Besides, unsuitable technologies or plans may be carried out due to the lack of experience that can only be obtained by serving consumers.

Moreover, it is left to the discretion of States to decide where the deployment is or not rapid enough, without any objective criterion. In the case of the “traditional” state aids, there is an objective criterion: the presence or absence of access network. No operator is able to anticipate if any concrete area may be subject to state aids in the future.

Some investors may be incentivised to slower their investments in the hope of getting state funds if they don’t deploy networks quickly enough. This would definitely be against the intended goals of the state aids, achieving in fact the opposed effect.

That NGA state aids therefore require a more rigorous and sophisticated analysis and a more careful approach cannot be seriously in dispute. This is where Telefónica believes the draft Guidelines still fall short. Currently they do not provide for an adequate level of regulatory certainty and could even hold back investment. These points are set out in more detail below.

In particular, Telefónica considers these state aid Guidelines in relation to broadband networks a good and timely effort to help to identify geographic differences that may need a differentiated approach to deployment.

Finally, Telefónica believes that State intervention to build publicly-owned networks should only be used where it is clearly stated that is indispensable to the attainment of the public interest objectives and the ancient networks become ineffective. Member States must ensure after identifying those geographic areas qualifying for public funding that an open, transparent and non-discriminatory

Public Consultation will be conducted with the aim of consulting with all stakeholders affected in those areas by the measure. Only in case that no private operator shows an interest to invest in a reasonable period of time within the corresponding geographic area, the local or regional authorities would be allowed to tender for the construction and management of a publicly owned broadband infrastructure.

Prior Steps and Alternative Measures

In order to achieve certain public policy goals state aids should be a measure of latest resort. There are other less distortive measures that Member States should take first or rule out as ineffective, before the Commission can allow the use of public money for the construction of (public) networks. This “ladder of intervention” should be made more explicit in the Guidelines.

Telefónica believes investments to bring NGA networks to EU citizens should be privately funded and that there are various ways for governments to promote NGA investment and incentivise investors before it would have to resort to direct subvention.

In first instance an appropriate, more investment friendly regulatory environment should be ensured by the regulator. Given that a large part of the cost of deploying fibre networks is in civil infrastructure (like digging, laying down cables, in house-wiring, etc) access to civil works should be fostered to lower cost of network roll-out and increase the likelihood of private investment, e.g. by making available access to ducts utilities and not just that of the incumbent operator. Other measures could for example be to ease the acquisition process of rights of ways, accelerated processes of infrastructure sharing as well as other measures leading to lower capital cost of investment such as tax incentives.

Moreover, as stated thereafter Telefónica believes that public intervention aimed at the deployment of broadband networks should be firstly focused on rural and underserved areas to gap the digital divide and social exclusion of citizens.

Only if the above measures are deemed to be insufficient or ineffective should state aid be allowed to be considered regarding NGAN.

When the above measures are deemed to be insufficient and public funding is considered necessary there are competition neutral forms of support that should be explored first. In this context, Telefónica believes that one of the most effective measures could potentially be the subvention of in-building wiring. Depending on the architecture of the network (FTTH) the wiring in buildings would have to be

replaced by fibre and surprisingly it can amount to 50% of the total cost of such an NGA. By providing assistance for this work, the state would make the business case for investment in an NGA easier. The work can be carried out by a variety of contractors, independent of any telecom operator, and their services can be acquired through a transparent and non-discriminatory public tender process. In other words, public intervention in this part of access network in white NGANs areas would have less distortive effects than in any other part of the network and should be explored first as it could result in a positive business case for one or more private NGANs.

Last but not least, Telefónica believes that the public sector can play a very important role in boosting the demand side of broadband. The role of demand side effects is also very important and should therefore be considered by the Commission as a criterion in assessing the validity of financing NGN. Sustaining the demand for and take up of advance broadband services offered over NGN can have positive effects on operator's choice to invest in high speed networks.

Prioritising State Aids on “traditional white areas”

If public funding is going to be deployed to construct an NGA, Telefónica would argue for this to focus first on traditional “white areas”, in other words in areas where there is no broadband access infrastructure at all. A well targeted state intervention in the broadband field can contribute to reducing the “Digital Divide”, defined as the gap between those individuals and communities that have access to broadband services and those that have not.

These are areas with a challenging return on investment (RoI) in the business case or even below the threshold for a commercially viable investment, i.e., areas where the expected average revenue per user (ARPU) and user density equation leads to less than one commercially viable network. For reasons of e-inclusion and of rural development, i.e., to avoid a digital divide that would disadvantage citizens in such remote or rural areas, public subsidies could be judged appropriate. Such subsidies should, however, be structured in such a way that they complement, instead of compete, with market driven activities and shall encourage the evolution of different technologies.

Telefónica has serious doubts about any state funding of NGAs in “grey” areas.

According to the draft Guidelines state aids can be acceptable if they are used to support the deployment of NGAs in “NGA white areas” and “NGA grey areas”. Of

course the Commission requires a more detailed analysis but Telefónica has serious concerns about what the Guidelines are signalling here.

In particular, Telefónica is concerned about the possibility of state aid in grey areas. This would mean possible public support for the building of a second NGA network where a privately financed NGA network already exists. One consequence of that could be that one possibly profitable NGA network gets supplemented by publicly supported one and likely rendering both infrastructures unprofitable.

Telefónica believes that another consequence of allowing the option for state aid in NGAN grey areas is that that the uncertainty created by such a possible scenario will most likely discourage or even prevent private investment in NGAN grey areas. Why would an operator deploy a NGA network in a new grey area if it can either expect state aid or could be faced with a competitor that has been given state aid to build out its NGA? It is better for him to wait and see. This “crowding out” is contrary to the aim of the Guidelines, namely wanting to accelerate the deployment of NGAs.

A similar effect seems already to be at work in the United States as a result of the economic stimulus package of the US government. According to the Financial Times¹ rural phone carriers in the US were “paralysed” unsure how to deal with the possibility of subsidies.

If the market deems a second NGA unprofitable or too risky and the single NGA leads to undesirable outcomes vis-à-vis competition and service provision there is a regulatory framework to remedy such market failures. In particular, competent authorities already have the power to define ex-ante or ex-post remedies in broadband markets and thus the remedy in such a case should not be sought in giving state aid. State aid can not be justified when there is a market failure for which there is already ex-ante regulation. State aid combined with ex-ante regulation to existing networks (traditional or NGAs) can compound the distortive effects on competition. This coexistence or duplication of remedies should be analysed and prevented. The introduction of a subsidies network could modify the competitive situation in a given area and in this case, and after an immediate market analysis, NRA should remove any ex – ante regulation imposed on existing traditional or NGN networks.

A key feature of the assessment proposed by the Commission could lead to duplication of networks because it doesn't take into account the progress of technological developments. It may be incorrect to conclude, when making an assessment today, that a certain network will in future not be able to provide

¹ Financial Times, “Shovel-ready broadband stimulus”, by Thomas Hazlett, 1 May 2009.
<http://www.ft.com/cms/s/0/af900dd0-3699-11de-af40-00144feabdc0.html>

certain high speed services. As an illustration, download speeds of 24 MB/s first seemed impossible on copper networks, but with the introduction of ADSL2+ they did become reality.

State aids in “NGA white or “NGA grey” areas also seriously risk distorting the market and investment incentives, especially when those areas are where there are “traditional broadband networks” that can be upgraded to an NGA network.

From a strictly legal perspective, state aids in “grey” areas are difficult to be justified in accordance to article 87 ECT and the secondary law and case law developing it. Any state resource addressed to finance an alternative network in a grey area should be considered as an unlawful state aid if it distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods in so far as it affects trade between Member States. Therefore, the four criteria that the ECT establishes in article 87.1 will be fulfilled in almost all the hypothetical cases.

Moreover, the justifications contained in article 87.3 will hardly apply. As in grey areas there is already a NGN deployed, the economic development of a region argument could only be alleged where the prices were higher and the quality lower as to impede the development of the concerned regions. In that eventual case, the Member State should be able to determine a less distortive mean to reach the goal (ex ante regulation, i.e. cost oriented prices), as the deployment of a new network would be very harmful for the pioneer investor. That hypothesis could discourage operators from deploying networks in white areas. Therefore a very careful and balanced assessment should be rendered by the European Commission.

State Aid in areas with traditional broadband networks (New White areas) can still lead to distortion.

The draft Guidelines attempt to address the situation of state aid for NGAs by almost ignoring the existence of traditional broadband infrastructures². It is Telefónica’s view that the Commission draft guidelines makes too strict a separation between “traditional networks” and “NGA” networks. When defining the areas for NGAs, no account is taken of existing broadband networks whilst the reality is that there often already are one or more traditional broadband infrastructures. This is the big difference between most state aid decisions on rural broadband and the new scenarios the Commission is describing in the draft Guidelines.

² Copper based, coaxial cable based and/or mobile broadband.

Telefónica believes that in the draft Guidelines the Commission underplays the distortive effect NGA state aid could have on these traditional broadband networks. This is, at least in the short and medium term, incorrect. At this moment in time there are very few if any services that can be qualified as of special social interest and that can only be provided over NGA infrastructure and not by, for example ADSL2+ technology. It appears difficult to demonstrate in advance that needs are not being sufficiently satisfied by current generation broadband networks in a given area. NGA network subvention in such a case would not contribute to solving a 'digital divide' and, on the contrary, it would clearly distort competition in the broadband markets, as traditional broadband infrastructures would be adversely affected by the public funded new networks.

Furthermore, in areas where there is no broadband infrastructure at all this wide definition of "White NGA" areas risks, for example, discouraging investment in xDSL and mobile broadband outside urban zones, as a private investor could fear its investment be devalued by publicly-financed NGA investment. In other words, the problem with this approach is that it can lead to a self-fulfilling prophecy. For example, once it is decided that an area is "white", it will probably remain so, due to the impossibility to compete with NGAs developed with the help of public funding. So, wherever Member States decide that an area is "white", they are actually making it "white".

According to the draft, the grant of state aid for NGA networks in 'white NGA' areas is to be subject to demonstration by the Member State concerned that *"there are no less distortive means (including ex ante regulation) to reach the stated goals."* Telefónica welcomes this condition which corresponds to the requirement of proportionality. However, it remains unclear in the draft how *ex ante* regulation could contribute to achieving the goals pursued by state aid in a given area where no NGA is deployed yet. We therefore suggest to specify in pt. 68 that

*"[.] there should be no less distortive means (including **adapting ex-ante regulation to provide better incentives for investment in new and enhanced access networks**) to reach the stated goals."* .

The distortive effects of NGA subvention have to be carefully weighed against the benefits of this new infrastructure. As that is currently less obvious, the Guidelines should therefore be more restrictive when it comes to NGA state aid in "traditional black areas" or "new white areas".

The Guidelines are insufficiently Technology Neutral

The Guidelines give a very specific definition of an NGA network, depending on the technology used. Thus, NGAs are defined as involving:

- laying fibre to existing street cabinets offering the prospects of downstream bandwidths of a minimum of 40 Mbps and 15 Mbps upstream” (FTTN)
- “upgrading current cable networks to deliver speeds up to and beyond 50 Mbps against the previous maximum speed of 20 Mbps, using the new 'DOCSIS 3.0' cable modem standard,”
- “connecting newly built homes and offices with fibre connections offering services up to 100 Mbps and beyond” (FTTH)

The existence or not of NGAs in a given area will then be determined by the existence (or planned deployment) of the above referred technologies.

This definition lacks any relationship with actual market demand. People don't demand a concrete technology, they demand services, and they don't care about the used technology. The important thing is if people in the area can access advanced Information Society services, not if there are fibre connections in the area.

Aspects of this definition, such as the speed, seem very arbitrary and haven't been substantiated by the Commission. By setting them the Commission effectively makes technology choices which goes against the general tenet of Community regulation in the field of telecommunications, which is technology neutral. Speeds are not only determined by the technology used, but are also actively set by the operator on the basis of market demand and in close cooperation with the manufacturer. This is also true for the differential between the upload and download speed.

Telefónica believes that the definition of NGA should be neutral from a technology point of view, and that it should be related to specific services. State Aid measures are required to be technologically neutral, as required in the Guidelines. Moreover, the most efficient technology for catering for the needs of each are may change from one are to another. In order for getting the most from the state funds, it is in their own interest that they are directed to the most efficient technology in each case.

The result could be that state aids are used to deploy solutions that may not be regarded as NGA by the Guidelines. Later, this could give place to further Aids, because of the area still lacking of NGAs, in spite of State Aids having already being allocated to this goal. This does not seem desirable from any point of view.

Following this line of reasoning, it is important to mention that the RSPG, trying to reinforce the principle of technological neutrality, has recently presented its position paper on the related question of **wireless broadband** stating that “*Wireless broadband, based on radio spectrum, is one of the most promising new services: it could help the EU economy recover while bridging the digital divide*”,³ The position paper emphasises the importance of removing unnecessary restrictions on the use of spectrum that is already in use for services that include mobile broadband and *it warns public authorities not to distort competition by favouring one type of infrastructure over the others when subsidising the roll-out of new telecommunications networks.* So, the most effective NGA strategy will probably use a mixture of technologies depending on local circumstances.

Unclear Definitions

Some not clearly defined concepts are included which could create legal uncertainty and give room for Member States’ discretion as: “market failure”, “adequate service”, “non-adequate access market conditions”, “affordable price”, “sufficient market conditions, “not effective access”.

It is really relevant in the whole Community Guidelines a more clear and precise definition of the “market failure” which is deemed to be addressed by public intervention.

Regarding the term “adequate service” there are several mentions in the consultation document which seems to have a pivotal role in the Commission’s assessment:

According to section 33 of the Guidelines, “*Where the market does not provide sufficient broadband coverage or the access conditions are not adequate, state aid may play a useful role*”.

According to section 39, “*Although a network operator may be present in the zone targeted by the State intervention, certain categories of users may still not be adequately served in the sense that either some broadband services requested by the users were not available to them*”.

³ ERG website: http://www.erg.eu.int/documents/docs/index_en.htm

or their prices were not affordable compared to the same services offered in other more competitive areas or regions of the country”.

According to section 40, the Commission “*may declare compatible, under certain conditions, State aid measures that target areas where the provision of a broadband infrastructure is still a de facto monopoly provided that (i) no affordable or adequate services are offered to satisfy the needs of citizens or business users and that (ii) there are no less distortive measures available (including ex ante regulation) to reach the same goals*”.

Furthermore, the Commission’s assessment under Article 87(3) seems to be based on the number of (adequate) networks existing in the targeted area.

However, the Commission does not define the notion of “adequate services” in its Guidelines. So, Telefónica proposes to define the term of “adequateness” (or the lack thereof) in relation to clear thresholds above which one can safely conclude that the services provided are adequate or could potentially be adequate through limited additional investment. The Commission could either (i) adopt a bottom threshold for broadband services (1/2 MB/s) or (ii) indicate an acceptable ratio between speed available in the area (i.e. a service is not adequate if it offers a download speed 50% lower than the average incumbent speed in that area)

TIMELINES

In the draft Guidelines the Commission uses a time criterion of 5 years to assess the colour of the areas and whether or not it is justified to give State Aid. If there appear to be no plans by any private operator to invest in an NGA network in an area for the next 5 years, it can be classified as “white NGA”. If there is one area where there is only one NGA network in the coming 5 years, it can be classified as “Grey NGA”, and it is justified to provide State Aid under certain conditions.

However, a nationwide NGA network will take a long period to roll out 10 – 15 years or even more. This means that some areas would by definition be deemed an “NGA White area” even if an operator has plans to roll out in a particular area.

Telefónica would prefer the Commission to take a longer and more sophisticated perspective on the timeframe for NGA developments. The development of NGANs will probably follow the same pattern of development of current broadband networks, that started by covering the densest areas first and developed progressively to other areas. Studying socio economic factors related to demand would also be a necessary exercise in this context, in order to avoid that public

funding is directed to the typical areas where privately funded NGAs are likely to appear.

Therefore, this criterion of likely future investment within the next 5 years should be more flexible and adaptable to market conditions or/and to specific regional circumstances due to a high degree of uncertainty in the conditions demand and to a high degree of technological development.

Madrid, 22 June 2009