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Backdating of FPP prices in New Zealand

Prepared for Spark and Vodafone

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DotEcon Ltd
17 Welbeck Street
London W1G 9XJ
www.dotecon.com

Content

Executive Summary

We find strong theoretical and empirical support for the majority view - not to backdate - in the Commission's Further Draft Determinations. Within the context of the current Final Pricing Principle (FPP) even if final prices were 'better' or more accurate than prices established in the Initial Pricing Principle (IPP) backdating would not lead to better outcomes. For backdating to be efficiency enhancing, a number of necessary conditions must have been met, namely (1) backdating must have been expected, (2) final prices must have been predictable and (3) parties must have been able to behave as if final prices had already applied. The FPP process does not meet these conditions. Where backdating has been applied in overseas jurisdictions, this has been in specific circumstances that are different to those that apply to the FPP determination.

This report looks at the arguments for and against backdating the final prices for unbundled access to Chorus' copper local loop and unbundled broadband access that the New Zealand Commerce Commission (the Commission) will establish on the basis of the cost modelling undertaken under the Final Pricing Principle.

The Commission first suggested that it was minded to backdate such prices to 1 December 2014 in its Draft Determinations, published in December last year. However, in Further Draft Determinations, published in July this year, the Commission has indicated it will not backdate the FPP charges. This view was not unanimous, with one Commissioner arguing that backdating should take place. The Commission noted that its decision will be guided by the purpose statement in Section 18 of the Telecommunications Act, which means that backdating would have to *"promote competition in telecommunications markets for the long-term benefit of end-users of telecommunications services within New Zealand."*

We look at the effects of backdating and whether backdating might create efficiencies through promoting better decision-making. Our starting point is that such efficiencies would have to be related to the expectation of backdating in future instances, as changing prices retroactively will not undo any decisions that have been made in the past and will thus not change outcomes from past behaviour. This view is shared by the Commission.

Taking this prospective view, we find that an expectation of backdating of prices that could be regarded as being in some way 'better' or more accurate because they have been established through more detailed analysis may create benefits, but if (and only if) a number of conditions are met. These include that the parties whose decisions would be affected can accurately predict whether

and on what terms backdating will take place and what the level of backdated prices will be. In addition, the parties must be able to act on the basis of these expected prices instead of prices that are effective at the point in time when such decisions are made. These conditions are unlikely to hold in practice.

A further, and more clear-cut benefit from the expectation of backdating is that the transfer of wealth from prices being changed retroactively sometimes removes the gains from deliberately setting 'wrong' prices (perhaps in breach of legal obligations) or from delaying the process that would establish the 'correct' price level.

Against these potential benefits, one has to set the additional uncertainty that is created through the expectation of backdating. The expectation that current prices might be changed through a future backdating decision removes the ability of parties engaged in transactions to rely on these prevailing prices. Current revenues and costs become uncertain and subject to future retroactive adjustments. This increases the volatility of revenues and costs, and is likely to discourage investment.

This implies that there may be more reason for backdating in dispute resolution processes, where such backdating can correct for the effects of actual wrongdoing and discourages delaying tactics that might otherwise be profitable for the party that benefits from the wrong price. By contrast, there is little, if anything, to support the use of backdating in standard regulatory determinations.

Our review of illustrative examples of how backdating is used in practice (in other jurisdictions and in other regulated industries) provides support for this. Backdating is commonly used in the case of dispute resolutions to discourage regulatory gaming and provide compensation for those who have suffered losses as a result of wrongdoing. By contrast, backdating is not generally used in – and regarded by some as being incompatible with – ex ante regulation where regulatory bodies set prices on a prospective basis. The downside of backdating in terms of undermining legal certainty and discouraging investment has been highlighted in some cases where regulators have resorted to backdating to make up for their failure to meet statutory deadlines.

On this basis, we find strong theoretical and empirical support for the majority view in the Commission's Further Draft Determinations. Even if they were 'better' or more accurate than prices established on the basis of benchmarking under the Initial Pricing Principle (IPP), backdating prices established through cost modelling under the Final Pricing Principle (FPP) does not necessarily lead to better outcomes, as one has to look at the prospective effects of an expectation of backdating.

Because of the nature of the decision that the Commission will ultimately take under the Final Pricing Principle, the benefit of backdating in terms of shaping future expectations are limited. Even if they were, it is unreasonable to assume that parties in similar

settings in the future would be in a position accurately to predict the outcome of an FPP determination and be able to take decisions on this basis. If this were the case, and uncertain expected FPP prices were to result in better outcomes than certain IPP prices, this would entirely undermine the case for the use of the IPP. Rather than setting IPP prices, which might possibly be revised at some later date, the Commission could simply instruct parties to take their decisions on the basis of their best guesses of the outcome of a prospective FPP determination.

1 Introduction and background

In December 2014, the New Zealand Commerce Commission ("the Commission") published Draft Determinations in which it set out its emerging view on whether the monthly charges for unbundled access to Chorus' copper local loops and unbundled bitstream access that it would eventually determine under its Final Pricing Principle (FPP) should be backdated.[1] In this consultation, the Commission expressed the view that it had discretion to backdate its FPP determination without being required to do so, and that it was minded to backdate monthly FPP charges to 1 December 2014.

A "*key reason*" in favour of effectively replacing IPP prices from this date with FPP prices given by the Commission was that "*the FPP price can be seen as a correction of the 'proxy' IPP price, the FPP price being a more accurate implementation of forward-looking cost-based pricing*".[2] The Commission set out that any final decision on backdating would be guided by the purpose statement set out in Section 18 of the Telecommunications Act ("the Act"), and that it would therefore need to show that the decision to backdate would need to be "*demonstrably efficient*" and "*demonstrably promote competition in a way that is likely to directly benefit end users.*"[3] Section 18 of the Act stipulates that the purpose of the Act is "*to promote competition in telecommunications markets for the long-term benefit of end-users of telecommunications services within New Zealand.*"

On 2 July 2015, the Commission released Further Draft Determinations for UCLL and UBA pricing accordance with the FPP, and final pricing decisions are expected for December 2015.[4] In these documents, the Commission expresses a majority view in favour of not extending the regulatory period for FPP prices to 1 December 2014, with one of the three Commissioners arguing that FPP prices should be applied from 1 December 2014 and that retail

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[1] New Zealand Commerce Commission, *Process and issues update paper for UCLL and UBA pricing review determinations*, Consultation Paper, 19 December 2014 ("Process and Issues Paper").

[2] Process and Issues Paper, paragraph 16.

[3] Process and Issues Paper, paragraph 15.

[4] New Zealand Commerce Commission, *Further draft pricing review determination for Chorus' unbundled copper local loop service* ("Further Draft UCLL Determination") and *Further draft pricing review determination for Chorus' unbundled bitstream access service* ("Further Draft UBA Determination"), 2 July 2015. In terms of the approach to backdating, the Further Draft UBA Determination defers to the considerations put forward in the Further Draft UCLL Determination.

service providers (RSPs) should compensate Chorus through a lump sum settlement of the difference between the higher FPP charges and the current IPP charges.

Both the majority view and the minority view appeal differently with reference to the authority of the purpose statement set out in Section 18 of the Act. Specifically, the arguments put forward in support of the majority view are:

- Because the retail market can be considered to be 'workably competitive', any difference between the actual prices charged and the backdated charges would have been passed through to consumers. This suggests that backdating should only be implemented through a claw-back mechanism, which would introduce further distortions from prices above costs that cannot 'undo' previous distortions that might have resulted from prices being too low.
- Looking at the impact that the expectation of backdating may have on future investment, it is not clear that there is any major new investment decision that would be subject to the IPP/FPP approach, and that in any case "the IPP/FPP error is symmetric and non-systematic."[5]
- Even though conceptually an expectation of backdating via lump sum adjustments may provide an incentive for RSPs to adopt the Commission's draft prices earlier, or undertake their own TSLRIC modelling in setting retail prices (instead of relying on IPP charges, for example), which would imply that better price signals become effective earlier, it is not clear that it would be appropriate or reasonable to expect RSPs to do so in practice, not least because the discretion of future Commissioners cannot be fettered.
- Because the Commission controls the timing of the FPP process, potential benefits from an expectation of backdating in terms of discouraging delaying tactics are not relevant.

By contrast, the dissenting view is supported by the following arguments:

- The earlier start to the regulatory period would allow the Commission "*to effectively meet*" the statutory preference for a 1 December start date for the UBA FPP price, which flows through to UCLL.
- Backdating with a lump sum payment will "*promote incentives to get more accurate FPP prices into the market place as early as possible*" and "*reassure investors that they*

[5] Further Draft UCLL Determination, paragraph 886

need not be reliant on less accurate benchmarking processes at any point"[6] and would be conducive to regulatory consistency, given that in order to sustain public confidence in the Commission it would be necessary to backdate charges if FPP prices were lower than IPP prices as not doing so in this case would allow Chorus to retain an excessive rent, which would be inconsistent with the pricing principle.[7]

We have been asked by Spark and Vodafone to:

- review the arguments for and against backdating, both from a conceptual perspective and with reference to decisions that have been made by other regulators and in other regulated industries, and to
- assess the relative merits of backdating in the current regulatory context.

We address these two requirements in the remainder of this report.

Specifically:

- Section 2 provides a conceptual discussion of the pros and cons of backdating, and uses the discussion about backdating and backdating decisions in other jurisdictions and other regulated industries to illustrate the key issues in relation to backdating.
- Section 3 applies these considerations to the specific context of setting regulated charges within an IPP/FPP framework, and looks at the arguments put forward in the Commission's Further Draft UCLL Determination in support of the majority view and the dissenting opinion.
- Section 4 concludes.

[6] Further Draft UCLL Determination, paragraph 899

[7] Further Draft UCLL Determination, paragraph 903

2 The pros and cons of backdating

Retroactive rule-making and retroactive rate-making[8] are generally frowned upon. Legal certainty and predictability are undermined where material terms on which decisions have been made are subsequently changed by an agency, in particular where the decision makers can reasonably assume that they can rely on the terms in place when they make their decisions. Perhaps not everyone would agree with the view of a US State Supreme Court labelling the retroactive application of rate changes as a practice that "*would be odious to the generally established notions of justice, and would moreover, be utterly subversive of the policy and utility of any system of rate regulation; for no rate could be relied on as stable*"[9], but nonetheless the question of whether and under what conditions regulators should backdate rates has been controversial in many jurisdictions.

In this section, we look at the potential justifications for backdating and use examples of backdating decisions from other jurisdictions and other industries to highlight considerations relevant to the Commerce Commission's forthcoming final Determination.

2.1 The effects of backdating

The starting point for our analysis is to look at the effects of backdating, where it is instructive to distinguish the impact of *applying* backdating in a particular instance and the impact of the *expectation* of backdating.

What do we mean by backdating?

In general terms, backdating involves the retroactive application of some terms and conditions to transactions that lie in the past. Backdating thus retrospectively changes terms and conditions that were in force in the past, and may generally be considered where

[8] It is worth pointing out that the rule against retroactive rate-making also rules out consideration of past losses and past profits when setting future rates. This is well-aligned with the principles of price cap regulation that regulated firms should not be compensated for past losses and should not be forced to surrender past profits in order to create incentives for finding efficiency gains (see for example David E M Sappington and Dennis L. Weisman, "Price Cap Regulation: What Have We Learned from 25 Years of Experience in the Telecommunications Industry?", *Journal of Regulatory Economics*, vol. 38, 2010.)

[9] Quoted in Stefan H Krieger, "The Ghost of Regulation Past: Current Applications of the Rule Against Retroactive Ratemaking in Public Utility Proceedings", *University of Illinois Law Review* 1991, no. 4 (1991).

these historic terms and conditions were in some way 'wrong' and where – with hindsight - different terms and conditions should have applied. In the specific case of backdating prices that are determined at some point in time to a previous point in time, this implies that past transactions between parties (such as access seekers and access providers) that took place at prices that were in effect during the backdating period are re-valued at different prices.

Even where past market outcomes may be inefficient, changing prices retrospectively will not make these outcomes more efficient

Regardless of the basis on which the parties involved have made their historic purchase decisions, "*the retrospective implementation of prices cannot influence decisions already made*"[10], as the Commission has quite clearly stated. Bygones are bygones, and changing prices (or other terms) with retroactive effect does not change what happened in the past. If the decisions that have been made on the basis of prevailing prices have been inefficient, then this situation is not going to be improved by backdating prices. Regardless of whether the backdated price is 'better' or 'more accurate' (e.g. derived from a more detailed cost modelling exercise), applying this price retroactively in itself does not improve past outcomes.

Because backdating cannot, in any specific instance, change what has happened in the past, it is purely a transfer of wealth between parties that have transacted with each other on terms that were different from the ones that are now presumed should have applied. The extreme position against retroactive rate-making historically held in the US rests on the assumption that there cannot be any justification of such a transfer as long as the past transactions were lawful.

2.1.1 Potential benefits from expected backdating

Incentive effects arise from the expectation of backdating

Incentive effects from backdating therefore arise only to the extent that parties expect that, under certain conditions, the prices that they face at a particular point in time might later be changed with retroactive effect. As the Commission has put it, it is the "*expectation of retrospective implementation at some future date*" that influences decisions.[11] The underlying assumption is that parties that expect prevailing prices to be changed with retroactive effect at a later date should be acting on the basis of their expectations rather than on the basis of prevailing prices, and the simple case for efficiency benefits from backdating presupposes that because the backdated prices are, in some sense, better or more accurate,

[10] Further Draft UCLL Determination, paragraph 853

[11] Further Draft UCLL Determination, paragraph 853; emphasis added

market outcomes arising from decisions based on these expectations will be better.

For the expectation of backdating to lead to better outcomes a number of conditions need to hold

However, even under the assumption that the later price is in some way 'better' or more accurate, the expectation of backdating will only lead to efficiency benefits in a very limited range of situations. For efficiency benefits (i.e. 'better' decisions) to be achieved, all of the following conditions must hold:[12]

- First, in any particular instance, parties must correctly predict that backdating will take place.
- Second, parties must correctly predict to what point in time the future price will be backdated.
- Third, parties must be able to predict the 'correct' price that will eventually be determined with a reasonable degree of certainty. Replacing prevailing prices with expected backdated prices in the parties' decision-making is unlikely to create efficiency benefits when expectations held by parties are likely to be wrong (and potentially by a considerable margin).
- Last but not least, parties must be in a position to behave, during the period prior to the backdating being confirmed, as if the future prices already apply. This cannot be taken for granted. For example, competitive access seekers who obtain access services at a price that is lower than the one they expect will ultimately prevail, may not be able simply to set their retail prices at the level suggested by the higher expected access price; competition is likely to force retail prices down to a level commensurate with the lower access price, even if access seekers expect this to be adjusted retroactively. This is particularly the case where expectations about the price that will eventually be set differ across multiple access seeking parties (even if such expectations are correct on average).

[12] It is worth noting that in practice backdating may not be an all-or-nothing decision, but that there may be additional parameters (such as the way in which any clawback would be affected, the total sums that should be clawed back, or whether interest should be applied). All of these parameters add to the uncertainty and would have to be predicted correctly for decision efficiency to improve.

These conditions cannot be assumed to hold in general, which means that benefits from backdating cannot be taken for granted.[13]

The wealth transfer that is part of every backdating decision can have a disciplining effect

A second source of potential efficiency benefits from the expectation of backdating arises from the fact that the transfer of wealth that is inherent in any backdating decision removes the potential benefits to one party from deliberately setting 'wrong' prices (e.g. in breach of a legal obligation) or delaying the process that leads to the determination of a more accurate price. In these cases, backdating removes (or at least limits) the potential upside from acting illegally or engaging in delaying tactics. In cases of breaches of legal obligations, backdating amounts to the extraction of unlawful gains made by the party overcharging to provide compensation for the victims' losses.[14]

2.1.2 The costs of backdating

Backdating creates uncertainty and additional risks, which could discourage investment

Against these potential benefits from backdating, one has to set the associated costs. These costs arise because the expectation that prices could be backdated creates uncertainty.

Unless a party has correctly predicted whether backdating will take place, the point in time to which prices will be backdated, and the actual backdated price that will apply, and has acted upon this prediction, the party will gain or lose when a backdating decision is actually made. With prevailing prices having been different from those that are applied retroactively, backdating implies a flow of funds from the seller to the buyer if prices have historically been too

[13] It is worth emphasising that the Court of Appeal in *Telecom v ComCom* (CA75/05, 25 May 2006) does not appear to have considered that benefits from applying a 'better' price from an earlier date must be linked to the expectation that such backdating will occur, and that these benefits are therefore contingent on the conditions set out above. It is unclear whether the Court has implicitly assumed that all of these conditions hold, but as a matter of economic logic, the presumption that applying prices that arise from a further review or from using a cost modelling framework instead of a benchmarking approach with retroactive effect must be beneficial because these prices are 'better' is unjustified.

[14] Note that the expectation of having to surrender the gains obtained from overcharging does not guarantee efficient behaviour for a number of reasons. First, the supplier might have some expectation of being able to get away with such behaviour, which means that pure restitution of benefits is an insufficient deterrent and additional fines would need to apply. Second, the actual harm suffered by the customers may exceed the amount of the overcharge because they would have bought more at lower prices, gaining additional benefits. This makes the quantum of damages in such cases a complex issue. Note also that there may be good reasons for requiring such transfers that compensate victims of wrongdoing and penalise wrongdoers through a transfer from the latter to the former regardless of any incentive effects that might flow from backdating. These reasons are primarily rooted in concepts of natural justice and fairness.

high, or in the other direction if prices have historically been too low. Except in the case where all parties have acted on the basis of perfect foresight (i.e. correctly predicted the backdated price and made effective provisions for the associated transfer), backdating will create winners and losers.[15]

If the parties' expectations are correct on average rather than in each and every case, expected gains and losses may cancel each other out. However, revenues and costs are subject to additional uncertainty as they will only be known at the point at which the backdating decision is actually made: the expectation of backdating removes the certainty over prices during the backdating period. Instead of being based on a known set of prices, decisions have to be made on the basis of expectations about what these prices will eventually turn out to be. This increases the volatility of revenue and cost streams, as the following simple stylised example shows.

Backdating increases volatility of revenues and costs

Consider a setting with two periods. In period 1, the prevailing price is p. The expectation is that the regulator will set a price at the beginning of period 2 that is distributed uniformly within an interval $[p^\star - d, p^\star + d]$. For the sake of simplicity, assume that parties trade one unit per period, so that revenues for the access provider (and costs for the access seeker) are the same as prices. We also ignore discounting of future revenues and costs.

If the price set at the beginning of period 2 will not be backdated, revenues are uniformly distributed over the interval $[p + p^\star - d, p + p^\star + d]$. The expected revenue is $(p + p^\star)/2$, and the variance of revenues is $d^2/3$.

By contrast, if prices will be backdated, then revenues are distributed uniformly over $[2(p^\star - d), 2(p^\star + d)]$. The expected revenue is $p^\star$ and the variance is $4d^2/3$; it has increased fourfold. The expected backdating will therefore not only provide incentives to act as if the first period price had been $p^\star$, which – if parties can behave in this way– could be expected to lead to better outcomes as $p^\star$ is assumed to be more accurate, but also lead to a considerable increase in the volatility of revenues and costs.

The additional uncertainty that arises in a world where prices may be backdated is likely to have a detrimental impact on investments. Even if backdating may imply that 'wrong' prices are corrected, this process involves a greater volatility of revenue and cost streams over the entire investment period. In particular where investments are to a large extent sunk, there may be considerable option values

[15] For the avoidance of doubt, it is the *threat* of those gains and losses and the desire of parties to *minimise* them that provides the incentives for acting upon expected rather than prevailing prices. Gains and losses from backdating are not an undesirable side effect, but the mechanism by which parties are incentivised to predict the outcome of an expected backdating decision to the best of their abilities, and act accordingly in advance.

associated with delaying investment until some of the uncertainty has been resolved. In this case, there will be clear costs associated with increasing the volatility of revenues and costs.[16]

Gains and losses may cancel out provided that parties' expectations are, on average, correct, and that they can, and do act, on the basis of expected future prices rather than the prices that apply during the backdating period. Both of these assumptions may not hold in practice, and there may therefore be reasons to be concerned about the impact of such a wealth transfer.

The welfare cost of this additional uncertainty needs to be set against the potential benefits from the expectation that 'wrong' prices will be corrected with retrospective effect and that decisions are therefore based on the (correct) prediction of more accurate prices at an earlier point in time.

2.2 Backdating in practice

In this subsection, we set out the general practice relating to backdating decisions in other jurisdictions that demonstrate how the considerations identified above are reflected in practice. More detailed information about the individual examples can be found in the Annex.

We should emphasise that this overview is not intended to provide a representative sample of backdating decisions that have been taken, and there is no suggestion that the examples discussed are representative of precedent relevant to the current case. Rather, they constitute a selection of cases that illustrate how the considerations set out above apply in practice.

Further, the overview should not be read as an indication of the prevalence of backdating. Outside of dispute resolution processes,

[16] A full discussion of the impact of uncertainty on investment is beyond the scope of this paper. There seems to be broad agreement that uncertainty discourages investment, even though there are some conditions under which uncertainty can theoretically have a positive impact on investment. For a general analysis of the link between uncertainty and investment, see for example Ricardo J Caballero, R J (1991), 'On the Sign of the Investment-Uncertainty Relationship', *American Economic Review* 81 no. 1 (1991); Sudipto Sarkar, "On the Investment–uncertainty Relationship in a Real Options Model", *Journal of Economic Dynamics and Control* 24, no. 2 (2000); Bastian Schwark, "Influence of Regulatory Uncertainty on Capacity Investments – Are Investments in New Technologies a Risk Mitigation Measure ?", *mimeo* (no date) or Nick Bloom, Stephen Bond, and John Van Reenen, "Uncertainty and Investment Dynamics", *Review of Economic Studies* 74, no. 2 (2007). For a discussion of the impact of uncertainty on investment and dynamic efficiency with specific reference to telecoms, see for example Niels Muselaers and Robert Stil, "Regulation, risk and investment incentives", *OPTA Regulatory Policy Note 06* (2010).

where backdating is more commonly considered, the retroactive application of prices is the exception rather than the rule. In particular, backdating occurs only exceptionally in standard regulatory determinations with some commentators suggesting that backdating is conceptually incompatible with the concept of *ex ante* regulation. This is particularly evident within the EU, where the *ex ante* approach to telecommunications regulation generally supports the definition of new wholesale products and their pricing in advance of their launch. This is intended to allow competing operators access to information about wholesale options which will become available with sufficient time for them to prepare competing retail offers. While the European market and regulatory structure differ from that in New Zealand, the EU approach offers an example of providing full information to stakeholders in a market ahead of change.

2.2.1 Backdating in standard regulatory determinations

Backdating is not generally used for standard regulatory determinations. Some views suggest that backdating is incompatible with the prospective nature of *ex ante* regulation.

ACCC applies changes to previous decisions prospectively rather than retroactively

The ACCC appears to follow a general practice of applying modifications of previous decisions prospectively. For example, on 29 June 2015 the ACCC released a further draft decision on access prices for Telstra's copper network, which revises an earlier decision from March this year that will see charges for seven access services fall by 9.6% from October 2015 onwards.[17]

Similarly, in the process of setting access charges for wholesale ADSL services, the ACCC in 2012 put in place an interim determination with the objective to provide greater certainty over prices until a final determination could be made[18], and decided not to backdate the final determination in spite of calls to do so. Specifically, the ACCC pointed out that its approach to backdating is different in the context of access determinations and dispute resolutions because the need to limit regulatory gaming is much reduced in cases where the authority controls the process.

[17] See https://www.accc.gov.au/media-release/accc-draft-fixed-line-services-decision-sees-one-off-uniform-fall-in-access-prices-of-96

[18] See ACCC, 2012, Interim access determination for the wholesale ADSL service - Statement of Reasons

Move from benchmarking of termination rates to LRIC-based rates in Europe did not involve backdating but glidepath to achieve a gradual reduction

The evolution of the EU approach to regulating fixed and mobile termination rates (FTRs/MTRs) resulted in substantial reductions of MTRs in particular, but these reductions have not been backdated.[19]

Specifically, the methodology for deriving regulated termination rates set out in a Commission Recommendation[20] required member states to move to set termination rates based on BU-LRIC. The EC indicated that there would be a transitional period to allow member states to develop their BU-LRIC models, and a further transition period for member states which were subject to resource constraints and could not comply with the EC's timescale. In the case of those member states that argued that they could not meet the timescale, the approach was that they could use alternative methodologies (primarily benchmarking), but that the result should not be higher than the average of the termination rates set by member states which were using BU-LRIC models. Although the EU output of the cost modelling exercise indicated that the prevailing prices for MTRs across Europe were much higher than would be justified by considering costs, the approach to reducing them was generally via a glidepath over several years. For example, in the Netherlands, a decision on an MTR target rate was taken in July 2010, along with a glide path of stepped reductions to get to the BU-LRIC rate in September 2012.[21]

UK Court of Appeal finds that Ofcom does not have the power to make retrospective adjustments

In the UK MTR case, Ofcom had put in place retroactive adjustments to mobile termination rates following a direction from the CAT in response to a complaint made by BT. The mobile operators appealed this decision and the Court of Appeal ruled in their favour, finding that the CAT did not have the power to direct Ofcom to adjust these rates retrospectively. The Court's reasoning was that the CAT could not order Ofcom to take actions that Ofcom would not otherwise be empowered to take, and that Ofcom was not empowered to amend existing SMP conditions with retrospective effect because its powers were to set SMP conditions with prospective, not retrospective effect. The Court specifically noted that the principle of ex ante regulation as expressed in the

[19] This evolution is an example of how a regulatory body made a shift from deriving regulated prices based on benchmarking to deriving prices from a standard cost modelling methodology. For the purposes of this report, our interest is on the impact on national pricing decisions rather than an exploration of the EU process of moving from benchmarking to modelling.

[20] Commission Recommendation of 7 May 2009 on the Regulatory Treatment of Fixed and Mobile Termination Rates in the EU (2009/396/EC), 20.05.2009

[21] Commission decision concerning case NL/2013/1481

European Framework and Access Directives imply that regulatory measures have to be forward-looking.[22]

ComReg's refusal to backdate USO funding emphasises protection of reasonable expectation of other operators

In Ireland, ComReg rejected Eircom's request for retrospective funding for its Universal Service provision. In refusing Eircom's request for backdating, ComReg emphasised that it had not previously received any request for funding, and that allowing Eircom to claim compensation retrospectively would be unfair given that other operators would have made their commercial decisions on the reasonable assumption that no such compensation was due.

Backdating in Singapore to enable IDA to approve tariff applications on an interim basis

The Singapore Infocomm Development Agency (IDA) in its first triennial review of the Telecoms Competition Code (TCC) proposed the inclusion of backdating powers in order to enable it to approve tariff applications on an interim basis. Specifically, the IDA considered that it would give such approvals subject to retroactive adjustment if the IDA upon review concluded that some elements of the tariff were in contravention of the TCC.[23]

Following the consultation, backdating was introduced in order to enable the IDA to approve tariff applications quickly on an interim basis and allow it additional time for review. We note that under this framework it would be clear to the parties involved that any tariff approved on an interim basis would be subject to backdating if it were non-compliant with the TCC. This should provide strong incentives only to make applications for the approval of tariffs that are compliant with the TCC. In any case, we are not aware of any instance where the IDA has since made use of its powers to adjust tariffs retroactively.

[22] In this regard, it is interesting to note that the European Commission regards any change in prices – including changes applied retroactively – as a material change in the scope of regulatory obligations that would need to be notified under the Article 7 procedure, as becomes apparent from decisions made in response to notifications from the Italian and Greek regulators. The Annex contains more detailed information.

[23] Section 4.4.3.2 (e) of the draft Code Of Practice For Competition In The Provision Of Telecommunication Services for consultation in October 2003. The provision remains unchanged in the Code as eventually adopted. We note that StarHub in its response to the consultation had argued for wider backdating powers to be applied in disputes, referring to the approach taken by the ACCC (amongst others) and arguing that in order to address the incumbent's "*incentive to obstruct negotiations and create an access dispute, delaying access to a new entrant … the existing regulatory regime needs to be amended to allow for the backdating of final IDA determinations to the date on which the parties commenced negotiations.*" (Starhub Pte Ltd, 2003, *Telecom Competition Code - First Triennial Review, Submission by StarHub Pte Ltd to the Info-communications Development Authority of Singapore*, paragraph 1.3.)

Powers for the regulator to backdate are enshrined in primary legislation in Portugal

ANACOM in Portugal has the power through primary legislation to impose changes to the incumbent's reference offers, and to apply these changes retroactively. Changes include changes to prices, and recently, ANACOM has reviewed the level of penalties imposed by the incumbent on access seekers and determined that penalties should be reduced and also that the incumbent has to reimburse operators that have already paid penalties at the previous rate. The EC has accepted ANACOM's approach without comment, but it should be noted that, in addition to its legislative basis, ANACOM has taken a long time[24] to initiate market reviews and to approve the incumbent's reference offers and the retroactive application of remedies is intended to compensate for that. Even in this case, and with being empowered to do so, ANACOM has only backdated penalty charges rather than access charges.

Backdating has been ordered by the courts in a number of instances in the electricity sector to correct for serious regulatory failures

Backdating has been used in the electricity industry in the face of substantial revenue shortfalls suffered by the utilities. For example, the Spanish electricity sector is plagued by an "*accumulated electricity tariff deficit of €30 billion*" (in 2013), which is "*the result of the unwillingness of different governments since 2001 to pass on the full costs of their policy decisions to customers.*" Specifically, it is *"the result of setting regulated (grid) 'access' tariffs too low to recover all the recognized costs of regulated activities."* [25] When the Ministry of Industry froze power tariffs between January to September 2011, two power companies appealed the decision to the Supreme Court. The Supreme Court ruled in favour of the operators, ordering the Ministry of Industry to increase access charges and to backdate these revise charges to January 2011.[26] A decision to freeze tariffs in the face of a substantial and growing deficit can be considered to be a serious regulatory failure.

A different concern triggered a court order requiring backdating in the French electricity sector. In France, the government regulates

[24] For example, the EC expressed concern about the "*unjustified delay of ANACOM's notified market review; the fixed termination market was last reviewed in 2004 i.e. 9 years ago*", The EU Framework Directive expects market reviews to be undertaken at least every 3 years. PT/2013/1491

[25] David Robinson, "Pulling the Plug on Renewable Power in Spain", Oxford Energy Comment, The Oxford Institute for Energy Studies (2013). In 2011, the Spanish Government set up the Spanish Electricity Deficit Amortisation Fund to finance the claw back of tariff deficits by utilities that had built up over a long period where regulated charges were set well below cost and amounted to €30bn by 2013. Consumers pay surcharges on their retail tariff to finance this fund, which in turn awards securities (backed by the Spanish Government) to the utilities in accordance to their entitled repayment sums (see European Commission, "Electricity tariff deficit: Temporary or permanent problem in the EU", *European Economy, Economic Papers 53* (2014)).

[26] CNE, 2012, Spanish Energy Regulator's National Report to the European Commission (2012).

retail electricity prices by capping the rate at which incumbent electricity and gas companies may increase retail prices each year. In 2012, the government capped the allowed increase in retail electricity prices for households, small and medium firms to 2% per annum, whilst production costs were increasing at a faster rate over the same period. The Association of Alternative Power Providers (Anode) made up of small generation companies who compete against EDF challenged the price cap set by the government at the Supreme Court on grounds that the artificially low price cap made it difficult for these companies to compete against EDF.[27] The Supreme Court ruled that the permitted increase of 2% was indeed insufficient to cover increases in costs over the period and ordered revised prices to apply retrospectively in the 12-month period in which the cap was in place. French consumers faced an increase in electricity rates as result.[28] To the extent that the backdated rate increase implied higher charges than those that would otherwise have been permitted going forward, it appears to be aimed at correcting a past distortion (incumbent prices having been too low) with a future distortion (where higher energy prices by incumbents provide more headroom for the new entrants). The regulatory failure in this case is linked to the fact that retail price regulation has a direct impact on the ability for competitors to thrive in the market, and that setting regulated charges too low immediately frustrates the development of competition. The backdating decision is aimed at creating compensating distortions in the retail market rather than creating incentives for efficient behaviour.

An example of backdating to correct for interim determinations that were set at a level that is substantially different from the final determination is the case of the Bulgarian electricity sector, where the regulator – without consultation – had set interim grid access fees for suppliers of energy from renewable sources at a level that was about one hundred times the level of the final determination. Obviously, such a gross error, with interim charges being different from final charges by orders of magnitude may justify correction through backdating, but it is equally obvious that this is an exceptional case of regulatory failure.

[27] Note that this is not a dispute between access seekers and access providers, but a challenge brought by competitors to the regulated firm who were unable to compete in the face of retail prices having been set so low that they would not be able to earn a sufficient margin.

[28] Bloomberg, 11th April 2014, French court cancels edf rates, deemed too low to cover cost (see http://www.bloomberg.com/news/articles/2014-04-11/french-court-cancels-edf-rates-deemed-too-low-to-cover-costs)

2.2.2 Backdating in dispute resolution processes

In practice, backdating is common in dispute resolution processes where the option for a regulator to backdate its decision is seen as an important measure to discourage delay tactics by access providers and to provide compensation for past losses. Such processes involve an act or omission by a regulated firm being contested, with all parties involved being aware of the fact that these acts or omissions may not comply with legal obligations from the point at which the dispute is raised. This is very different setting from the case where a price has been set by a regulator even if there is scope for the regulator to set a different price at a future point. It is also worth pointing out that the main focus in these instances is on predictability, supported by backdating powers explicitly set out in law and guidelines about how these powers will be exercised.

Discouraging delaying tactics

ACCC guidelines regard backdating as a means to discourage regulatory gaming

For example, the framework put in place by the Australian Competition and Consumer Commission's (ACCC) in relation to its powers to backdate the final determinations it makes in arbitration proceeding to resolve access disputes in telecommunications and, more broadly, under Australia's National Access Regime. Specifically, the ACCC has set out guidelines that identify the main rational for backdating as reducing the incentives for access providers to delay such proceedings, and which highlight that the ACCC, though generally inclined to backdate in these cases, will take into consideration the behaviour of the parties to an access dispute when making this decision (see the description in the Annex for further detail).

The Australian regime not only acknowledges the benefits of guidelines on backdating, but explicitly requires the ACCC by law to establish such guidelines with a short period of the corresponding provisions coming into effect. This clearly confirms the point that certainty over whether, and under what conditions, backdating would take place is important to minimise uncertainty and create the strongest incentives for parties in an access dispute not to delay proceedings and to try and anticipate the price that the ACCC will eventually determine.

Interestingly, the ACCC considers interim determinations as an alternative to backdating, where the distinct advantage of an interim determination – if set 'towards the price' that is likely to be established in the final determination – is that an efficient price can be brought into effect earlier without the uncertainty revolving around backdating.

ODTR used threat of backdating against Eircom

The threat of backdating was also used by the Office of the Director of Telecommunications Regulation (ODTR, the predecessor of the present regulatory body ComReg) in 1998 in order to encourage incumbent operator Eircom to provide the information required by the ODTR to assess the incumbent's reference interconnect offer.

Compensating for losses

Backdating may be used to compensate parties for past losses that they have suffered as the result of unlawful behaviour.

In the UK backdating can be used to correct for over- and underpayments

For example, Section 190(2)(d) of the UK Telecommunications Act provides Ofcom with the power "*for the purpose of giving effect to a determination by OFCOM of the proper amount of a charge in respect of which amounts have been paid by one of the parties of the dispute to the other, to give a direction, enforceable by the party to whom the sums are to be paid, requiring the payment of sums by way of adjustment of an underpayment or overpayment*."[29] It was with reference to these powers that the CAT directed Ofcom to order mobile operators to compensate BT for the difference between charges for the termination of calls to non-geographic numbers introduced by BT in 2009 and the charges previously in place with retrospective effect. This direction was given after lengthy proceedings in which the Supreme Court ultimately confirmed BT's right to vary charges for such calls in the manner it had done in 2009.[30] The way in which backdated charges were calculated took into account the reasonable expectations that mobile operators would have had at the various points in the past (i.e. prior to Ofcom's determination and between Ofcom's determination and the success of BT's appeal to the CAT, which was later overturned by

[29] We note that Ofcom's predecessor organisation Oftel considered that providing compensation for past losses would be a matter for the courts rather than the regulator. Stating that it had received a number of dispute notifications asking for a retrospective application of any adjustments to interconnection charges it might make, Oftel notes that it considered its role to be limited to dispute resolution as a "*a means … to swiftly resolve disputes that arise due to the particular nature of communications markets (ie disputes about access and interconnection involving players which are dominant) … It is Oftel's role to resolve disputes in such a way as to secure the objectives of the EU Directives. The question of damages or compensation are not issues that Oftel considers when resolving a dispute but are issues that should be pursued by complainants through the courts.*" Consequently, *"[a] decision to make a retrospective determination will be taken on the merits of the case in hand … taking account of the ability of operators to have raised issues at an earlier date. However, operators should not seek retrospective decisions as a way to obtain compensation or damages from dominant operators for anti-competitive behaviour.*" See Oftel, "Dispute resolution under the new EU Directives - A consultation by Oftel and the Radiocommunications Agency" (2002).

[30] BT v. Telefonica O2 and others [2014] UKSC 42.

the Court of Appeal and reinstated by the Supreme Court). It is worth emphasising that backdating in this case was not intended to impose a different price with retroactive effect, but rather confirmed the validity of the price that had been set prior to litigation.

This suggests that backdating decisions should take into account the losses suffered and the reasonable expectations that parties could have held. The question of loss arose, for example, in the context of Ofcom's LLU decision, where a request from Opal and Sky to backdate LLU charges that Ofcom had to revise following an appeal was rejected on the grounds that the access seekers had not suffered a loss from higher prices (and that Openreach had been in compliance with its regulatory obligations).

2.2.3 Backdating to make up for delays in the regulatory process

There are some instances where backdating has been used to make up for delays in the regulatory process, though in many cases this has drawn strong criticism because of the detrimental impact on legal certainty and investment incentives.

Backdating has been used fairly regularly in Italy because the regulatory process was delayed

The Italian telecoms regulator AGCOM has regularly applied price controls retroactively in various markets. The main reason for this appears to have been that AGCOM has been slow in commencing market reviews and collecting the information required in order to update regulated charges, and in approving Telecom Italia's reference interconnection offer. There have also been delays in agreeing costing methodologies with the European Commission. While the reason behind the retroactive application of remedies differs from the New Zealand case, the European Commission's comments on the impact of backdating remedies is relevant.

The European Commission, in its response to notifications of draft regulatory measures under the Article 7 procedure[31], has been commenting on these retroactive applications in Italy since at least 2012, emphasising the need to ensure that retroactive application of price changes did not impinge on legal certainty for operators which were providing services on the basis of previously imposed obligations. This comment was repeated in several responses to notifications.

[31] Article 7 of 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, as amended by Directive 2009/140/EC, OJ L 337, 18.12.2009, p. 37, and Regulation (EC) No 544/2009, OJ L 167, 29.6.2009, p. 12.

As notifications continued to involve retroactive price controls, the European Commission explicitly asked AGCOM to avoid setting new prices with retroactive effect as such retroactive price changes can have a negative impact on operators' incentives to invest in the deployment of NGA networks. With what one might consider to be a thinly veiled expression of exasperation, the European Commission ultimately stated that it *"urges AGCOM to ensure that the procedures for the approval of cost oriented prices that are not subject to network caps be predictable for participating parties and as effective as possible, so as to avoid risks of delay and the need for corrections to the extent possible. In the event that that implementation of the measure will show that it is impossible to maintain a yearly timetable of price approvals that avoids retroactivity, AGCOM should consider whether a different pricing methodology would provide greater stability and predictability."*[32]

Overall, the responses from the Commission indicated clearly that backdating should not be used as a way of formally complying with deadlines while actually missing them. There seem to be little, if any, efficiency benefits from an expectation of backdating where the delays are due to the regulator, and backdating only has the costs associated with increased uncertainty for industry players.

We understand that some backdating of regulatory charges is taking place in Greece because the annual audit of the incumbent's cost takes place after the date at which regulated charges for a particular year become effective (though only if the cost audit implies that charges should be reduced). We are not aware that the European Commission has raised formal concerns about this, and note that all market participants seem to be aware of this practice. However, as with the Italian example, there are no perceived benefits associated with this approach, and its tacit acceptance for the time being should be seen as a pragmatic means of making up for discrepancies in the regulator's processes.

[32] Commission Decision concerning case IT/2015/1733; emphasis added. The issue of retroactivity and the detrimental impact that retroactive adjustment has on the market also figures prominently in the country overview in the latest Implementation Report (European Commission, "Implementation of the EU regulatory framework for electronic communication – 2015", Commission Staff Working Document (2015), in particular pp 171 – 172).

Backdating a price cap in the Netherlands to balance the interests of access seekers and access providers in the face of a substantial delay from litigation

Another example of backdating of regulatory charges is provided by the Dutch regulator's (OPTA, now ACM), decision to apply price caps retrospectively because the process of setting new caps was substantially delayed through legal challenges. It is worth pointing out, however, that in this case the regulator has attempted to balance the interests of access seekers and the incumbent KPN by backdating to a point in time that would divide the retroactive charges into two equal parts between KPN and the access seekers. In doing so, the regulator considered both the impact of a complete retroactive application of the cap on the financial position of access seekers, and the fact that they could have reasonably expected the outcome of KPN's appeal on the other hand. It is also worth noting that the delay in this particular instance was the result of legal challenges rather than fully within the control of the regulator[33].

2.3 Implications for the approach to backdating

This analysis of the effects of backdating and the way in which backdating is used in practice suggest a few general principles that should be followed in relation to backdating decisions:

The threat of backdating discourages regulatory gaming, which is not relevant where the process is controlled by the regulator

First, there is a clear distinction between using backdating in dispute resolution processes, which are explicitly about the question what terms and conditions should have applied to transactions between the parties from the time the dispute is raised. In these processes, the focus is on discouraging delaying tactics by the parties to the dispute and the compensation of victims (whether of unlawful behaviour or mistakes made by the regulator) and normal regulatory determinations. The threat of backdating can provide a powerful incentive to discourage regulatory gaming (including the incentives to bring unjustified litigation), which is not relevant where the process is controlled by the regulator. By contrast, the use of backdating in standard regulatory determinations arguably conflicts with the ex ante nature of such regulation.

The 'when' and 'how' of backdating must be predictable

Second, in order to maximise the incentive effect and minimise the detrimental impact from uncertainty, the conditions under which backdating will take place, and the principles that will be applied when making a backdating decision, should be known in advance. Increasing the predictability of backdating decisions both reduces uncertainty and increases the impact that expected backdating will have on behaviour.

[33] Commission Decision concerning case NL/2014/1601, Brussels 06.06.2014

The case for backdating can be made when prevailing prices are manifestly 'wrong' and all parties are able to forecast 'correct' prices

Third the case for backdating is strongest where the benefits from improved decision making are large compared with the cost of uncertainty. This is most likely to be the case, for example, where prices are the matter of a dispute raised by the parties, or where one of the parties has superior information about what correct prices should be and is in a position to delay the process by which these prices will be implemented. In these cases, parties know that prevailing prices are likely to be wrong and may be expected to be able to predict the 'correct' prices that should apply with reasonable accuracy. By contrast, where prevailing prices have been set as part of a process that explicitly includes provisions for initial determinations and revisions in light of further analysis that is not straightforward and resource intensive, there are substantial benefits from the certainty associated with such initial determinations, unless they are grossly out of line with what might come out of a final determination. In these cases, perhaps the best way to ensure efficient behaviour is to provide an answer on which market participants can rely at the earliest opportunity rather than exposing them to the uncertainty that is associated with the retroactive application of a future determination. Even if this answer is only approximately right it may lead to a better outcome compared with requiring parties to act on the basis of their best guess of what the correct answer might ultimately be.

Backdating has little justification when parties cannot predict final prices, or control the price-setting process.

Fourth, by implication there is little, if any, justification for backdating where prevailing prices are not manifestly wrong, where parties cannot be expected to predict the correct price with reasonable accuracy, and where the process that leads to the determination of the correct price is not controlled by the parties to the transaction.

In particular, there is little justification for using backdating to make up for regulatory delays that are fully within the control of the regulatory body. Backdating in such cases has little discernible benefits in terms of establishing a consistent policy and a coherent framework that would allow market participants to form reasonably accurate expectations and only undermines certainty (even if regulatory delays were to occur with some predictability). Accepting that backdating is an acceptable way of meeting a missed deadline potentially distorts the trade-off between finding the right answer and finding a good answer quickly.

3 Implications for the Commerce Commission's backdating decision

In this section, we draw out the implications of our analysis of the effects of backdating and the examples of how backdating is used in practice for the case at hand.

Present case is not a dispute where regulatory gaming would be a concern

The setting of price controls is part of the New Zealand framework of ex ante regulation. The two-stage approach involving the setting of prices first on the basis of an Initial Pricing Principle, relying on cost benchmarks and then – if parties are not satisfied with the benchmarked prices – a Final Pricing Principle involving full cost modelling is set out in the Telecommunications Act. The price set via the Initial Pricing Principle continues to apply unless and until replaced by a price set via the Final Pricing Principle. The case at hand is therefore a standard regulatory determination rather than the resolution of a dispute. It is entirely within the control of the Commission[34], and we are not aware of any concerns having been raised about lack of cooperation from the parties who are affected by the prices, or attempts to delay the process. This would suggest that there is no case for backdating a decision (or announcing an intention to do so) in order to correct for incentives to delay the process.[35]

[34] As pointed out by Commissioners Gale and Welson (Further Draft UCLL Determination, paragraph 893)

[35] In any case the regulator might well have other means of addressing the specific instance of failure to respond to an information request in a timely manner. For example, ComReg issued a notice of intention to prosecute Vodafone Ireland for failure to provide information on the timescale requested by ComReg for its review of the Fixed Voice Call Origination market. Vodafone was given 21 days to remedy its failure, and an initial fine of €1,500 (see ComReg Document No 14/111, 23 October 2014).

Even if FPP is more cost-reflective than IPP, imposing it retroactively does not improve efficiency

Even if one were to accept the view expressed by the Court of Appeal in its decision on Telecom v New Zealand Commerce Commission (CA75/05) of 25 May 2006 (at paragraph 35) that a "*revised price must be more efficient than the initial price [j]ust as an initial price is more efficient than a disagreement*"[36], it does not follow from an economic perspective that "*if a revised price were not to relate back that would in itself result in inefficiencies*". Applying such a price retroactively does not "*dictate the price for supply*" in any meaningful sense. Past decisions have been made on the basis of different prices – be they the prevailing prices at the time or the expectation of what the revised price might be (which would correspond to the actual revised price only if all the actors had had perfect foresight) – and the retroactive application of the revised price will not change the decisions that have been made. Put differently, the only way in which the revised price could be said to be more efficient is in relation to decisions that are being made on the basis of this price, and these are forward-looking decisions. This means that the retroactive application of a price will never in itself increase efficiency; by implication, not doing so cannot be inefficient in any specific instance.

Efficiencies must come from expectations, and here the predictability of backdating and the ability to predict FPP prices in future determinations matter

As the Commission correctly states (and as discussed above), any benefits that would be relevant under Section 18 of the Telecommunications Act (which are important matters for whether backdating is appropriate), must therefore be linked to the expectation of backdating FPP prices in future determinations. This then of course raises the issues discussed above, namely:

- To what extent would a decision to backdate FPP charges in this case make future backdating decisions more predictable?
- How accurately would access seekers and access providers be able to predict the outcome of an FPP determination at the point to which such a determination would be backdated? How likely would they be able to act based upon such a prediction, and how much better is the outcome likely to be when compared with making decisions based on IPP prices?

[36] One can reasonably argue with the proposition that a revised price must always be more efficient than an initial price as the process of revision is subject to errors and uncertainties and may introduce distortions that could result in the revised price being further away from the efficient price level. Although of course one would hope that the more detailed analysis under the FPP will produce a more reliable proxy of what the price of the services would be were they competitively supplied, one should not take such an outcome for granted.

Backdating in this case has limited impact on expectations

With regard to the first question, the Commissioners Gale and Welson note that *"[c]urrent Commissioners cannot bind future Commissioners to backdating: they will retain the discretion to backdate at any point at which that decision arises."*[37] The precedential value of a backdating decision in this case may be particularly limited because it is not clear that "*a major new bottleneck investment would be regulated by way of an IPP/FPP*" in the future, as Commissioners Gale and Welson state.[38] This in itself limits the potential benefits from backdating FPP prices in the current case in terms of guiding future expectations. Last but not least, we also understand that a major review of the Telecommunications Act and the regulatory framework is imminent, which would suggest that a backdating decision in this specific instance would have little, if any, value in terms of affecting future expectations.

It is unlikely that forecast FCC prices result in better decisions

In relation to the second point, Commissioners Gale and Welson are of the opinion that "*TSLRIC modelling requires significant judgment, so results can vary dramatically*", and that it is not necessarily "*reasonable to expect all RSPs to perform this type of modelling*."[39]

To this one has to add that even if RSPs could predict the outcome of an FPP determination with a reasonable degree of certainty, they might not necessarily be able to act accordingly. Again, Commissioners Gale and Welson acknowledge this.[40] Of particular importance in this case is that the expectations of RSPs are likely to differ. Even if RSPs were able to ignore prevailing IPP prices when setting their retail charges and act purely on the basis of their FPP predictions (which they might not be), competition should be expected to lead to prices that reflect the lowest prediction of future FPP charges amongst RSPs. If expectations are correct on average, this means that the actual FPP will be higher than the prediction on which retail prices have been set. Even if RSPs were aware of this potential problem, it is not obvious that they would be in a position to correct for it.

[37] Further Draft UCLL Determination, paragraph 887.2.

[38] Further Draft UCLL Determination, paragraph 886.6.

[39] Further Draft UCLL Determination, paragraph 887.2.

[40] Further Draft UCLL Determination, paragraph 887.3

If uncertain FPP price forecasts were to produce better outcomes there would be little point in establishing an IPP price (and having an IPP stage in the first instance)

In any case, if the parties involved in an IPP/FPP process could be expected to predict the eventual outcome of an FPP determination with a reasonable degree of certainty and behave in accordance with their prediction, this would for all intents and purposes render the IPP meaningless. Specifically, if the presumption is that parties would make better decision on the basis of their predictions of the outcome of an FPP process (even after taking account of the uncertainty associated with this) there would be little point in the Commission establishing an IPP price. It could simply announce that the FPP charges it will eventually determine will apply from the date at which a determination is sought without the need to set any price in the meantime. Economically, the IPP/FPP framework makes sense under the assumption that there are benefits from establishing an IPP price that might later be revised following a determination under the FPP because the IPP price, even if only a proxy, provides more certainty and thus a better basis on which parties can make their decisions. This requires, however, that the IPP price can be relied on as a basis for parties decisions unless and until replaced by a forward looking FPP price.

Commissioner Duignan's arguments in favour of backdating assume that doing so is beneficial because "*the most efficient price is applied and responded to earlier*"[41], referring to Spark's decision to increase prices immediately upon seeing the TSLRIC modelling results. It is not entirely clear whether this has been an attempt to accrue provisions for the case that prices would eventually be backdated[42], or – as Commissioners Gale and Welson note – simply a forward-looking decision that took account of the fact that the long run marginal cost of retaining or gaining new customers rose regardless of whether higher prices would be backdated.[43]

In any case, as noted above, it is far from clear that decisions based on uncertain expectations about FPP prices would necessarily be better than decisions based on IPP prices even if FPP prices more accurately reflected those that would pertain in a competitive market (namely prices based on the cost of a hypothetically efficient operator). Therefore, while Commissioner Duignan is right in pointing out that the retroactive application of FPP prices might have the benefit of *"reassure[ing] investors that they need not be reliant on less accurate benchmarking processes at any point"*[44], this argument misses the downside from the additional uncertainty that industry participants are facing during the periods where they have

[41] Further Draft UCLL Determination, paragraph 900.

[42] Further Draft UCLL Determination, paragraph 901.

[43] Further Draft UCLL Determination, paragraph 887.3.

[44] Further Draft UCLL Determination, paragraph 899.2.

to rely on their respective best guesses of what future FPP prices might be. By comparison, IPP prices that are certain (even though they might be based on less accurate benchmarking) are likely to be preferable.

Backdating cannot be justified because the Commission would have liked to complete the FPP process sooner

The validity of the argument that backdating effectively allows the Commission to comply with a statutory preference for an earlier start date is not questionable for a number of reasons. Backdating the FPP price does not mean that it has been effective in the market earlier. In any case, as discussed above, backdating determinations in order to make up for delays that are within the control of the regulatory body has a detrimental impact on investment incentives, and a belief that backdating is a way of retrospectively meeting missed deadlines might even be counterproductive where it makes the regulator more relaxed about actually meeting these deadlines in the first place.

Perhaps more importantly, even if such an argument were to be accepted in principle, it would not be applicable to the case at hand. The Commission has not failed to meet a statutory deadline and there is no previous price control that would have expired and be no longer valid. Charges have been set in line with the well-established IPP/FPP framework. There is no presumption that IPP prices are provisional, and there is no deadline by which IPP prices would have to be replaced by FPP prices (and indeed, no automatic requirement to establish FPP prices at all). That the Commission might have liked to complete the FPP process sooner cannot be a valid argument for backdating, which does nothing to change the actual timetable.

Consistency requires a policy on backdating, not of backdating – and developing guidelines would be more effective to establish such a policy

Last but not least, Commissioner Duignan argues that "*a policy of backdating is more conducive to regulatory consistency, which is vital to sustain confidence in the regulatory regime*" because "*it would be difficult to sustain public confidence in the Commission if Chorus was allowed to retain what would likely to be described as excessive revenue not consistent with the pricing principle.*"[45] There are a number of observations in relation to this argument:

- First, the argument relates to a general policy rather than the decision in this case. We are not aware that a general policy of backdating is in place, and as noted above, there are serious doubts that deciding to backdate in this case would be effective in terms of establishing such a general policy.
- Second, the emphasis on regulatory consistency is well placed, but this relates to a general policy in relation to

[45] Further Draft UCLL Determination, paragraph 903; emphasis added.

when and how to backdate, not necessarily a general policy that backdating must occur.

- Third, although we would not advocate such an approach, such a policy could conceivably be asymmetric in the sense that backdating would take place in cases where FPP prices are lower than IPP prices, but not in the other case, which would deal with concerns about allowing Chorus to retain what might be considered excessive profits. One potential justification for this approach could be that regulated charges that are too high lead to profits that are retained by the regulated firm, whereas access charges that are too low will not result in benefits for RSPs but will instead be competed away in the form of lower retail prices.[46]

[46] For the avoidance of doubt, we should emphasise that there are substantive downsides to such an asymmetric approach. First, it would be an example of regulatory hindsight bias that caps upsides without limiting downsides for regulated firms. Second, such an approach would also distort incentives for access seekers who, though purchasing access, will also retain the option of a retroactive rebate without having to rebate underpayments. This could distort make-or-buy decisions.

4 Conclusions

Applying our analysis of the effects of backdating and of examples of backdating in other jurisdictions to the specific case at hand leads us to conclude that there is no good argument for the Commission to backdate FPP prices in this particular instance.

The arguments put forward by Commissioners Gale and Welson are a fair reflection of the factors that need to be taken into account when considering the likelihood that better decisions would be made in the future if there were an expectation that backdating will take place. Doubts about the ability of parties correctly to predict FPP prices and act on the basis of such predictions mean that potential efficiency gains are small and likely to be dwarfed by the detrimental impact of increased uncertainty.

More generally, the view that better decisions would be made on the basis of expected FPP prices being backdated than on the basis of IPP appears to be inconsistent with the rationale for having an IPP phase in the first instance.

Annex: Supporting material

Australia

The 2002 guidelines for the resolution of access disputes in telecommunications published by the Australian Competition and Consumer Commission's (ACCC)[47] stated that the rationale for backdating final determinations, which the Commission was empowered to do pursuant to the Trade Practices Act 1974, was to deal with the problem that "*If the access provider has a lot to lose, its incentives to progress the arbitration may be weak. The objective of the backdating provisions is to reduce the incentives for delay. As noted in the [Supplementary] Explanatory Memorandum [for the Telecommunications Legislation Amendment Bill 1998] these provisions are intended to: '...encourage commercial agreement and co-operation during access arbitrations by removing incentives for delay and to ensure a considered and reasonable outcome is ultimately applied to the interim period which may otherwise be covered by an interim determination or a commercial agreement which one or more parties may be disputing.'*"[48]

The ACCC also notes that "*[g]iven that the backdating provision is intended to improve incentives, the Commission will, in general, be inclined to backdate determinations. That said, each case must be considered on its merits. In particular, the Commission is likely to consider whether the manner in which the parties have conducted themselves before and during the arbitration provides grounds for not backdating the determination… Considering the parties' conduct in this way improves incentives for the access provider to offer reasonable price and non-price terms and conditions, and reduces incentives for the access seeker to notify a dispute in the hope that the final price will be lower and backdated.*"[49] This clearly acknowledges that incentive effects arise from the expectations that the parties involved in a dispute have about backdating, and that these expectations are strongly affected by guidelines setting out how backdating decisions would be made.

[47] ACCC, Resolution of telecommunications access disputes — a guide, October 2002

[48] ACCC, Resolution of telecommunications access disputes — a guide, October 2002, p 57.

[49] Ibid.

It is also interesting to note that the backdating a determination in an access dispute is seen as an alternative to making an interim determination rather than as an adjunct that offers the opportunity retrospectively to replace a provisional rate with a final one. Specifically, the ACCC notes that "*[i]n considering whether an interim determination is appropriate in all the circumstances, the Commission considers a range of matters [including] whether backdating a final determination would provide an adequate alternative to making an interim determination*." [50]

The backdating provisions were carried over into subsequent versions of the guidelines, and specifically addressed the requirements set out in the Telecommunications Competition Act 2002 [51] which amended the backdating provisions in the Trade Practices Act 1974 by empowering the ACCC to include interest and requiring it to have regard to guidelines when exercising its powers to backdate. The ACCC was also required and to establish such guidelines within six months of the coming into force of these provisions.[52]

It is worth noting that the ACCC has received similar powers in relation to arbitration of access disputes under the National Access Regime[53], which also required the ACCC to establish guidelines for how it would exercise these powers within six months of the amendments coming into force. These guidelines also acknowledge that *"[t]he objective of the backdating provisions is to remove an incentive to delay the negotiate/arbitrate process"*.[54]

The role of backdating as a measure to discourage tactical delays in arbitration proceedings was also highlighted in the context of the

[50] ACCC, Resolution of telecommunications access disputes — a guide, October 2002, p 49; see also p 50 where the ACCC discusses the relative merits of backdating and making an interim determination, noting that interim determinations, when setting a price towards the price that will be set in a final determination, would be more effective in ensuring that the benefits from such a price are enjoyed earlier. This indicates that the ACCC does not believe that the parties to an access dispute would be making decisions on the basis of correct predictions of a final price determination.

[51] Telecommunications Competition Act 2002, No. 140, 2002

[52] Specifically, subsection 25 of the Telecommunications Competition Act 2002 stated that when exercising the powers under section 152DNA of the Trade Practices Act, the ACCC "*must have regard to any guidelines in force*" and must for this purpose "*by writing, formulate guidelines … [and] must take all reasonable steps to ensure that the first set of guidelines … is made within 6 months after the commencement of this subsection*."

[53] Trade Practices Amendment (National Access Regime) Act 2006, No. 92, 2006

[54] Paragraph 3.2.2 of ACCC, 2006, *Guidelines relating to deferral of arbitrations and backdating of determinations under Part IIIA of the Trade Practices Act 1974*

Australian Competition Policy Review, launched in 2013. In its response to the consultation, Virgin Australia proposed a 'negotiate-arbitrate' model for the regulation of airport services, which advocated a light touch regulatory approach under which parties would first commercially negotiate for airport services, with the authorities taking on a dispute resolution role should negotiations break down. In relation to the arbitration process and backdating of decisions, Virgin Australia noted that *"[T]he arbitration process should also provide for interim determinations and backdating of final determinations to ensure that there are no commercial benefits to any party from delaying the arbitration process"*. [55]

By contrast, backdating is not considered to be required where the regulatory authority is in control of the process and concerns about parties to the decision engaging in delaying tactics are greatly reduced. A clear example of such a case is the recent access determination for wholesale ADSL services (which had been declared in February 2012). Having commenced a public inquiry about its proposal to make a final access determination (FAD) in respect of the service, the ACCC decided to make an Interim Access Determination (IAD) because it did not expect the FAD to be made within a six month period, and considered that the "*the IAD will also provide additional certainty as to the terms and conditions of access to the Service until a FAD can be made*."[56]

When making its FAD in May 2013, the ACCC decided not to backdate the FAD but rather let the IAD stand for the period between the IAD and FAD. Though having received submissions asking for the FAD to be backdated because Telstra had allegedly gamed the process through unsolicited submission, the ACCC stated that in its view the complexity of the matter and the number of issues that had to be considered were responsible for the time taken. The ACCC specifically pointed out that in its opinion "*the approach taken in relation to backdating is different in the context of access determinations inquiries compared to the previous access dispute arbitration regime. While in an access dispute arbitration there was a tendency to backdate to limit regulatory gaming by an access provider, this is not the case in the context of access determination inquiries. This is because the ACCC has greater control over the process*

[55] Paragraph 3.5 of Virgin Australia, 2014, *Virgin Australia Submission to the Competition Policy Review*: http://competitionpolicyreview.gov.au/files/2015/01/virgin_01.pdf

[56] ACCC, 2012, Interim access determination for the wholesale ADSL service - Statement of Reasons, p 1.

of the inquiry and the concerns around regulatory gaming are less likely to arise."[57]

Bulgaria

Following an amendment to the Bulgarian Renewable Energy Act in July 2012 which required grid access agreements to be in place by 18 September 2012, the grid operator requested that the Bulgarian Energy Regulator (DKEVR) approve grid access fees for access of suppliers of energy from renewable sources, claiming that these suppliers were responsible for the majority of the grid operators' costs, and that the DKEVR put in place interim grid access charges that would apply while the DKEVR decided on final charges. In response to this request, and without consultation of other stakeholders, DKEVR announced access grid charges of 236 BGN (approx. 180 AUD) per MWh. These charges amounted to a substantial portion of the preferential feed-in tariffs agreed with producers of energy from renewables.[58]

DKEVR's decision on interim charges was subsequently challenged by the renewable energy providers and revoked by the Supreme Administrative Court in June 2013, with retrospective effect to eliminate windfall gains to the grid operator. In March 2014 DKEVR published its final determination of access charges - proposing access charges of around 1% of the interim charge (2.45 levs per MWh) for solar and wind power producers, with other renewable energy producers not facing any grid access charge. DKVER proposed that final access charges would be backdated to 18th September 2012. At the same time, a 20% tax on the revenues of solar and wind producers was proposed, though this was later struck down by the Bulgarian Constitutional Court in July 2014.[59]

The substantial difference between the interim and final grid access charges, as well as the change in scope of energy providers that

[57] ACCC, 2013, Public inquiry to make a final access determination for Wholesale ADSL service, Final Report, p 98.

[58] "Bulgaria's energy regulator moots grid access fee for renewables" (SeeNews Renewables, 24th January 2014, http://renewables.seenews.com/news/bulgarias-energy-regulator-moots-grid-access-fee-for-renewables-401072); "Bulgaria: Interim access fees decrease the income of renewable energy plants in Bulgaria" (Schönherr, 25th September 2012, http://www.schoenherr.eu/knowledge/knowledge-detail/bulgaria-interim-access-fees-decrease-the-income-of-renewable-energy-plants-in-bulgaria/)

[59] "Bulgarian regulator sets new grid access fee for wind, solar power producers" (SeeNews Renewables, 24th January 2014, http://renewables.seenews.com/news/bulgarian-regulator-sets-new-grid-access-fee-for-wind-solar-power-producers-409811

would have to pay these fees raises obvious questions about the approach taken by the DKEVR in setting an interim charge. While DKEVR was under pressure by grid operators to introduce the access charge as soon as possible, there was no information about how the interim charge was set, nor any attempt to consult with the industry.

Channel Islands

Wholesale ADSL charges

CICRA, in its previous incarnation as OUR, proposed to backdate changes to wholesale broadband access in Guernsey in 2006. The OUR carried out a review[60] of wholesale ADSL pricing charged by Cable & Wireless Guernsey (C&WG), and concluded that, based on an analysis of C&WG's costs, and some benchmarking, the price for wholesale broadband services should be reduced by 22%.

The OUR proposed to backdate this increase to the time when C&WG launched its wholesale service, around 6 months earlier. Note that the legislative basis for this is a Licence Condition (Condition 31 of C&WG's licence) such that:

"The Director General may determine the maximum level of charges the Licensee may apply for Licensed Telecommunications Services within a Relevant Market in which the Licensee has been found to be dominant. A determination may;

a) provide for the overall limit to apply to such Licensed Telecommunications Services or categories of Licensed Telecommunications Services or any combination of Licensed Telecommunications Service;

b) restrict increases in any such charges or to require reductions in them whether by reference to any formula or otherwise; or

c) provide for different limits to apply in relation to different periods of time falling within the periods to which the determination applies." (emphasis added)

Following consultation, the OUR decided to instruct C&WG to reduce its wholesale broadband prices by 15%.[61] Even although the OUR had the legislative basis to backdate the price change, and had signalled its intention to do so, the final decision does not

[60] OUR "Investigation into Wholesale Broadband Pricing", OUR 06/05, February 2006

[61] OUR "Investigation into Wholesale Broadband Pricing: Final Decision", OUR 06/13, May 2006

backdate the price reductions. There is no rationale provided in the published documents for this change from the consultation position to the final position. Discussion with the regulator indicated that the threat of backdating was seen as a means of ensuring that the incumbent did not introduce unreasonable delays into the process.

Mobile termination charges

CICRA has backdated changes to fixed and mobile termination rates in Jersey. In November 2012, in its review of MTRs[62], CICRA proposed to reduce the MTR cap for all mobile operators, and to backdate this to 1 April 2012. In parallel, CICRA reviewed fixed interconnection rates[63], and proposed to direct Jersey Telecom to reduce its rates, and to backdate the reduction to 1 April 2012.

There were no comments on the principle of backdating the reduction in rates. However, C&WJ requested CICRA to backdate further, on the basis that *"…JCRA [CICRA] had originally promised to take action to reduce FIRs in 2011."*

JT's objections to backdating were mainly practical, as it claimed it did not have resources to calculate and reimburse backdated fees due to the implementation of a new billing system.

According to the Regulator, the reason for backdating was procedural, as the process extended beyond the time of the previous control.

Greece

We understand that the Greek regulator EETT regularly undertakes an audit of the incumbent's costs usually in the period from March to May. As cost-based price controls are usually revised at the beginning of the year, this may lead to the backdating of regulated charges where these are required to be cost-oriented, and where the cost audit indicates that costs have decreased (which usually covers monthly fees for LLU). We are not aware that these price changes (including their retrospective application where applicable) have been notified to the European Commission.

In this regard, we note that the European Commission has reminded the EETT that changes to prices constitute a material change to a regulatory remedy and that even if the principle of setting an interconnection fee had already been imposed and

[62] CICRA "MTRs in Jersey: Final Notice", CICRA 12/55, November 2012

[63] CICRA "Fixed Interconnection Rates in Jersey", CICRA 12/54, November 2012

approved, a change to the actual fee had to be treated as if it were a new remedy. Specifically in July 2014, the EETT notified the European Commission of terms and conditions in granting access and interconnection , including setting a maximum interconnection fee for the routing of calls. In the notification, "EETT indicated that it had received several dispute resolution requests over the years regarding interconnection agreements, which it had resolved, without however having notified draft measures in these decisions under the Article 7 procedure."[64] Responding to EETT's notification, the European Commission commented:[65]

"The Commission recalls that under the Commission Recommendation on notifications, time limits and consultations provided for in said Article 7, price levels and methodologies used to calculate costs or prices are considered to be material changes to the nature or scope of a remedy that have an appreciable impact on the market and should therefore be notified under Article 7.

In this regard, the Commission stresses that any material changes to obligations imposed on operators constitute an amendment of regulatory obligations referred to in Article 16(4) of the Framework Directive and could have an effect on trade between Member States. Therefore, the Commission urges EETT to respect in the future the need to notify under Article 7(3) any modifications concerning price levels meeting the criteria referred to above".

Ireland

Interconnection rates

ComReg, in its previous incarnation as the Office of the Director of Telecommunications Regulation (ODTR), considered backdating interconnection rates in Ireland back in 1998.[66] The context was a review by the ODTR of the incumbent's Reference Interconnect Offer. The incumbent (Eircom) was obliged to publish a RIO which was to include transparent, cost-oriented and non-discriminatory interconnection rates, and the onus was on the incumbent to justify to the ODTR that it was compliant with this obligation.

The ODTR considered that it had not received sufficient information from the incumbent to allow it to come to a decision on the interconnection rates, and proposed that it would consider

[64] European Commission, "Implementation of the EU Regulatory Framework for electronic communication – 2015" Commission Staff Working Document (2015)

[65] Commission Decision concerning case EL/2014/1631.

[66] ODTR "Interconnection rates in the Irish Telecommunications Sector" ODTR 98/60, November 1998

backdating changes to any rates which were subsequently shown to have been too high. To the best of our knowledge, backdating did not occur, but the threat of backdating appears to have been used to remove incentives for Eircom to delay the process or withhold information.

USO funding

In 2007, ComReg considered Eircom's request for retrospective funding for its Universal Service provision[67]. Eircom was designated as Universal Service Provider in Ireland for the period 26 June 2006 to 30 June 2010, and as such was entitled to seek financial compensation for its provision of US.

Eircom proposed to seek retrospective compensation for the annual net costs of its universal service obligations that it claims it had incurred since July 1999.

ComReg refused Eircom's proposal on the following grounds:

- the Universal Service Regulations do not purport to have any retrospective operation prior to 25 July, 2003 (including back as far as 1999).
- ComReg had received no request for funding from Eircom since the coming in to force of the Universal Service Regulations prior to 11 May, 2006.
- the appropriate relevant period within which to assess Eircom's request should be the financial period during which Eircom submitted its application, namely that period commencing 1 April, 2006. Any fund would therefore apply only from 1 April, 2006.

In its decision ComReg noted that *"[t]he application of a fund to periods before 1 April, 2006, going back to 25 July, 2003, would be unfair to other operators since they would have made commercial decisions on the reasonable assumption that no fund was to be in operation. At the same time, ComReg notes that eircom could have submitted a request for funding at any time since 25 July, 2003, but chose not to."*

[67] ComReg "The provision of the Universal Service", Document No 07/07, 2 February 2007

Italy

In October 2012, AGCOM notified a draft measure under the Article 7 procedure[68] setting WLR prices for the period from 1 June to 31 December 2012, i.e. with retrospective effect.[69] The Commission raised a number of questions regarding methodology used to set prices, and commented on the retroactive application of regulated charged by inviting "*AGCOM to consider whether setting new WLR prices with retroactive effect (i.e. from 1 June 2012) might lead to legal uncertainty for market players. Against this background AGCOM is invited to ensure that the proposed WLR prices, applicable with retroactive effect, do not impinge on legal certainty for operators currently providing services on the basis of previously imposed obligations".* The Commission made the same comment in response to AGCOM's notification of January 2013 concerning price-related remedies in the markets for wholesale call origination, transit and termination, which proposed to set rates retroactively for 2012.[70]

In April 2014, AGCOM notified draft measures in relation to the markets[71] for access to the public telephone network at a fixed location for residential and non-residential customers (WLR prices), wholesale access to the local loop for broadband and/or voice services (NGA prices), and wholesale broadband access (VULA price remedies, NGA Bitstream and ancillary services prices) to the European Commission. Specifically, AGCOM proposed to approve Telecom Italia's Reference Interconnection Offer for 2013 and thus apply the prices in this offer retroactively for the year 2013.

In its response[72], the European Commission pointed out that it had commented on market measures previously in the earlier WLR case

[68] Article 7 of 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, as amended by Directive 2009/140/EC, OJ L 337, 18.12.2009, p. 37, and Regulation (EC) No 544/2009, OJ L 167, 29.6.2009, p. 12.

[69] Commission Decision concerning Case IT/2012/1384

[70] Commission decision concerning case IT/2013/1415; in this case, the Commission also opened a Phase II investigation which was, however, not concerned with the retrospective application of the proposed charges.

[71] Corresponding to markets 1, 4 and 5 in Commission Recommendation 2007/879/EC 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 (Recommendation on Relevant Markets), OJ L 344, 28.12.2007, p. 65

[72] Commission Decision concerning Cases IT/2014/1585, IT/2014/1586: IT/2014/1587.

(IT/201/1384), and as part of its comments had requested AGCOM to ensure that the retroactive application of the proposed WLR prices in that case did not impinge on legal certainty for operators.

In addition to further concern about AGCOM's methodological approach, the European Commission also raised questions about AGCOM's failure to notify its 2012 prices for markets 4 and 5, arguing that these constituted the implementation of price control obligations which had been defined in previous decisions that had already been notified. The European Commission responded that *"…price levels and amendments to the methodologies used to calculate costs or prices, are considered to be material changes to the nature or scope of a remedy that have an appreciable impact on the market and should therefore be notified"*.

Last but not least, the European Commission stated that it ***"****reiterates its previous comment and once more asks AGCOM to avoid setting new prices with retroactive effect (i.e. 2013), as this leads to legal uncertainty for market players and can have a negative impact on operators' incentives to invest in NGA networks deployment in Italy. Against this background, AGCOM is invited to ensure that the proposed prices for markets 1, 4 and 5, applicable with retroactive effect, do not impinge on legal certainty for operators currently providing services on the basis of previously imposed obligations."*

Looking ahead, the European Commission stated that it *"is aware that AGCOM is currently undertaking a full market review of the wholesale broadband markets in Italy for 2014-2016. The Commission urges AGCOM to finalise this market review as soon as possible, in particular as regards next generation access networks. The Commission considers it vital for the competition and investment environment in Italy that AGCOM sets future access prices in a forward-looking manner, and in any event prior to the relevant period under review"* (emphasis added).

In November 2014, AGCOM notified its proposal to approve TI's 2013 Reference Offer for wholesale network infrastructure access, end-to-end connectivity, which would again have retroactive effect. The European Commission reiterated its previous request that AGCOM avoid setting new prices with retroactive effect, noting that it "*would like to stress that the negative impact of retroactive measures on legal certainty is stronger when there are instances of unexpected tariff changes, which is the case of the present proposal to adjust the PTE [Building Termination Point] access fee.*

In this respect, the Commission urges AGCOM to finalise the market review of the wholesale broadband markets in Italy for 2014-2016 as

soon as possible, in order to set future NGA access prices in a forward-looking manner".[73]

In February 2015, AGCOM notified modifications to TI's Reference Offers, interconnection rates, and "administrative migration" from TDM to IP in the markets for wholesale call origination, transit and termination.[74] Under this notification, AGCOM would not change existing price controls with the exception of price caps for ancillary services, which would again be set retroactively. In a request for information following the initial notification, AGCOM had indicated that "*issues related to the Italian Ministry for Economic Development and the High Administrative Court have considerably delayed the notification of the 2013 price control remedies and of the 'administrative migration' procedure."* Whilst the Commission acknowledged this point, it stated that it "*[n]evertheless … reiterates its previous comment expressed in case IT/2014/1586 on markets 1, 4 and 5 of the 2007 Recommendation on relevant markets and requests AGCOM, whenever possible, to avoid setting new prices with a long retroactive effect (i.e. 2013), as this leads to legal uncertainty for market players and can have a negative impact on operators' incentives to invest in NGA networks deployment in Italy.*

Against this background, AGCOM is invited to ensure that the proposed prices for the markets under analysis, applicable with retroactive effect, do not impinge on legal certainty for operators currently providing services on the basis of previously imposed obligations".

In May 2015, AGCOM notified its review of the market for wholesale high quality access provided at a fixed location. In considering the proposed remedies, the European Commission commented as follows:[75]

"The Commission notes that for certain higher quality products outside of Baskets A and B a cost orientation principle has been established, which will require the approval of cost-based prices on a yearly basis in the context of the approval of Telecom Italia's Reference Offer.

The Commission notes that the date for the publication of the Reference Offer has been moved forward compared to previous practices to 31 July of the previous year, which is likely to improve the timing of the adoption of pricing decisions.

Nevertheless, past experience in this and other markets in Italy has shown that this mechanism can be administratively cumbersome and

[73] Commission Decision concerning case IT/2014/1650.

[74] Commission Decision concerning cases IT/2015/1719; IT/2015/1720; IT/2015/1721.

[75] Commission Decision concerning case IT/2015/1733.

incur delays, creating a risk of requiring the retroactive application of final pricing decisions.

The Commission urges AGCOM to ensure that the procedures for the approval of cost oriented prices that are not subject to network caps be predictable for participating parties and as effective as possible, so as to avoid risks of delay and the need for corrections to the extent possible. In the event that that implementation of the measure will show that it is impossible to maintain a yearly timetable of price approvals that avoids retroactivity, AGCOM should consider whether a different pricing methodology would provide greater stability and predictability." (emphasis added)

Netherlands

The Netherlands regulator has been involved in a 6 year process of setting wholesale prices, which has been subject to judicial review and European Commission comment.

In 2008, OPTA (now ACM) notified the European Commission of its market analyses for fixed telephony, leased lines, wholesale physical access and fixed voice call termination. Measures imposed in the market reviews included a price control remedy, based on a wholesale price cap.

In 2009, OPTA notified a measure determining the implementation of the price control remedy, which was to be applied retroactively from the beginning of 2009 until 31 December 2011. The measure was appealed in the Netherlands, and the judgement in 2013 ordered modification on specific points, with the timeframe extended until June 2014.

Although the original period under consideration in the price control was 2009-2011, price caps were imposed for 2012-2014 while the legal process was underway. According to the European Commission[76]:

"ACM considers that applying the decision with complete retroactive effect from 1 January 2009 would not be justified, as the retroactive charges would be of substantial magnitude for access seekers, given that additional costs will have an impact on operating results and cannot be passed on to end users. On the other hand, ACM balances these considerations against the interests of KPN, and the fact that the outcome of the appeal was a possibility known to access seekers for a long time. ACM therefore proposes to divide the retroactive charges into two equal parts between KPN and access seekers, by choosing 15

[76] Commission Decision concerning Case NL/2014/1601

February 2011 as the effective date of implementation of the revised price caps".

Portugal

The Portuguese regulator, ANACOM, notified the EC in August 2013 of proposed changes to the billing and collection of penalties applied by the incumbent operator to other operators under the reference offer in the market for fixed wholesale physical network infrastructure.[77] ANACOM proposed to reduce the penalties that the incumbent could charge other operators seeking access to poles where the other operator failed to provide records of specific cable installations within a certain time period. The Regulator stated that the penalties were excessive and not compatible with the principle of cost orientation. The proposed measure provided for the reimbursement of penalties that had already been imposed under the previous charging basis. The EC raised no objection to ANACOM's proposed measure, and did not comment on its intention to backdate the change in the charges which would be imposed through the incumbent's reference offer.

It should be noted that ANACOM has been granted specific power in primary legislation to impose remedies retroactively. Article 68 of the Electronic Communications Law states that:

The NRA may further determine:

a) Changes to published reference offers, at any time and where necessary with retroactive effect, to give effect to obligations imposed under the provision of article 66; [emphasis added]

b) The immediate inclusion of the imposed changes in the agreements concluded, provided that such changes have specific and sufficient content.

It should also be noted that the process of approving reference offers and setting regulated prices in Portugal has been subject to delay, and the EC has commented on this.[78] For example, when ANACOM notified its proposed approach and termination rates in the market for fixed call termination, the EC expressed concern about the 9 year delay since the previous review, and emphasised the need for regulatory predictability. The EC instructed ANACOM to introduce new rates as soon as practically possible, by way of provisional measures. Further, as far as we are aware, ANACOM has only retroactively applied reductions in penalty charges imposed by

[77] Commission Decision concerning Case PT/2013/1494

[78] Commission Decision concerning Case PT/2013/1491

the incumbent, and has not sought to introduce any retroactive changes in access charges.

United Kingdom

CPS charges

On 28 November 2003, Ofcom imposed "*a requirement on BT (in the form of SMP Condition AA8) to provide CPS and charge for the service on a forward looking LRIC basis.*"[79] Between September and November 2003, BT proposed revised charges for CPS and Ofcom carried out analysis to decide appropriate prices for BT to charge. Ofcom then published the CPS Direction in August 2005, "*which set the charges for CPS per provider set-up costs, CPS per provider ongoing costs and CPS per customer line set-up costs.*"[80]

After negotiating with the relevant CPS customers, BT offered to backdate the new charges to 28 November 2003 and repay the difference with interest. However BT stated that it would not be prepared to backdate changes to the level of penalties for CPS forecast shortfalls (i.e. charges that would be payable even if actual transaction volumes fell substantially below those that the CPS operator had forecast, and on the basis of which BT had incurred costs). The forecast shortfall penalty was not a charge that had previously been set explicitly by Ofcom. In the previous Determination, BT had made proposals to charge CPS operators for the higher of the actual number of transactions submitted, or 90% of the forecast transaction numbers. Oftel had accepted BT's argument that it had to incur costs based on such forecasts, and that it was important to be able to recover these costs even if the forecasts turned out to be too high.[81]

Opal rejected BT's offer of repaying the new charges back to November 2003 and argued that both the charges and the forecast shortfall penalty changes should be backdated further to 1 October 2002. A dispute was submitted to Ofcom, asking Ofcom to determine whether BT should have to repay the difference between the new charges and actual charges going back to 1 October 2002, and whether repayment should also cover charges for CPS forecasting shortfalls.

[79] Ofcom, Dispute between Opal Telecom and BT about retrospective CPS charges (2006), page 2.

[80] Ibid.

[81] Ibid, paragraph 4.33.

Ofcom developed a model to investigate BT's recovery of CPS costs over the period and identified that "*BT's break-even point (i.e. the point at which BT started to over-charge for the provision of CPS) falls between the period August 2003 and February 2004,*"[82] the mid-point of which is the end of November 2003. This was the approximate date to which BT offered to backdate CPS charges. Therefore, Ofcom decided not to force BT to backdate CPS charges to a period prior to their originally offered date.

However, Ofcom decided that BT should backdate the forecast shortfall penalty charges, but only to 28 November 2003. Ofcom states it's reasoning for this decision as that "*SMP Condition AA8.4 requires that the charges for CPS, including the forecast shortfall penalty, be based on LRIC.*"[83] The decision to require the inclusion of forecast shortfall penalties reflected Ofcom's view that even though these charges were not explicitly set by Ofcom, they were linked to the provision of CPS services and derived from charge components that were explicitly set.[84]

Termination charges for calls to non-geographic numbers

In 2009, BT changed the manner in which it determined charges for termination of calls to non-geographic number ranges beginning 08, 0845 and 087 on its network.[85] Specifically, BT set the termination charge payable by mobile operators in proportion to the retail price these operators charged their customers for such calls.

The mobile operators challenged BT's proposed revision of termination charges for non-geographic numbers under Ofcom's dispute resolution procedure. In its determination, Ofcom found in favour of the mobile operators, ordering BT to revert to its previous termination charges.

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[82] Ibid. paragraph 2.8.

[83] *Ibid.* paragraph 2.10.

[84] Specifically, Ofcom argued that it "*as the costs that BT is seeking to recover through the forecasting shortfall penalty charge are costs associated with the provision of CPS Facilities, BT is required to ensure that the forecasting shortfall penalty charge is based on LRIC in line with SMP Condition AA8.4. Ofcom does not consider that BT's argument, that the forecast shortfall penalty charge was not one of the charges specifically assessed by it in the August 2005 Direction and so should not be applied retrospectively, is relevant*." (Ibid, paragraph 4.35).

[85] BT issued Network Charge Change Notice 956 in respect to calls to 080 numbers on 3 June 2009 and subsequently, Network Charge Change Notice 985 and Network Charge Change Notice 986 in respect to call to 0845 and 087 numbers respectively on 2 October 2009.

BT subsequently appealed the Ofcom decision to the Competition Appeal Tribunal (CAT), which found in favour of BT. The CAT decision was in turn appealed by the mobile operators to the Court of Appeal who found in favour of the mobile operators, but this decision was later challenged by BT in the Supreme Court.

In 2014, the Supreme Court upheld the CAT ruling that BT had the right to alter termination charges for non-geographic number in the manner it had proposed, and ordered retrospective payments of charges to be made by mobile operators to BT. The CAT also directed Ofcom to determine the amounts that should be repaid based on the principles set out by the CAT judgement.

- For the period from when BT introduced to Ofcom issuing its determination requiring BT to reinstate the previous charges, the CAT found that payments should be made to BT in accordance with the termination revenues that BT should have made from the introduction of the revised termination but did not, as a result of the mobile operators ignoring the new charge structure introduced by BT.[86]
- For the period between Ofcom's Determination and the CAT judgement, given that Ofcom ordered BT to revert to status quo ante, the CAT considered mobile operators could reasonably rely on the Determination even though BT had appealed it to the CAT. For this reason, the CAT accepted that it would be inappropriate to determine the amount to be repaid on the basis of the actual charges levied by the mobile operators (which were set in reliance on Ofcom's determination), but rather on the prices that would have been set had the new termination charges been in effect. However, as the CAT acknowledged, calculating such counterfactual retail prices would be impossible, and therefore it ordered that the relevant prices should be those that the mobile operators put in place once they had a chance to respond to the new termination charges. Specifically, the CAT set a reference date - 28 days from the judgement – which would allow mobile operators to revise retail prices according to the new charge structure, and required that thee prices would then be used to determine

[86] Competition Appeal Tribunal, British Telecommunications PLC versus Office of Communication (Termination charges 0845 and 0870 numbers), case number 1169/3/3/10

the sums owed to BT for the period between Ofcom's Determination and the CAT judgement.[87]

The CAT's proposed calculations of payments to BT clearly reflects the reasonable expectations that parties could have had in the course of the legal process.

LLU charges

On 22 May 2009 Ofcom set a new price control in relation to LLU services, which came into force on 19 June 2009. The price control consisted of a price ceiling for 2009/10 and indexation of the ceiling for 2010/11. This decision was appealed by the Carphone Warehouse Group plc, Opal's then parent company, on the basis that Ofcom had made errors in the setting of the price controls. The matter was then referred to the Competition Commission, which found that Ofcom's determination contained material errors.[88]

On 11 October 2010, the Competition Appeal Tribunal decided to remit the 2009 decision back to Ofcom, directing Ofcom to adopt a revised price control on a prospective basis, taking into account the Competition Commission's findings. Ofcom published its revised LLU price control on 14 October 2010. The prices from October 2010 onwards were slightly lower than those that would have resulted under the original price control applying the original indexation.

On 7 February 2011, Opal submitted a dispute to Ofcom requesting that Openreach be ordered to repay to Opal an amount that reflects the difference between charges to LLU services between 20 June 2009 and 14 October 2010, to reflect the adjustments made to the LLU price control. Opal had been in negotiations with Openreach about these charges, but the parties had failed to come to an agreement. Ofcom, decided to handle the dispute on 21 March 2011. Following a dispute submission from Sky on 8 April 2011, the two disputes were joined.

Opal argued that Openreach should repay the difference between the 2009 price control set by Ofcom and the revised prices because even though Openreach's prices for this period were fully compliant with the price control set by Ofcom, they were not compliant with

[87] Paragraph 455-456, Competition Appeal Tribunal, British Telecommunications PLC and Everything Everywhere Limited versus Office of Communications, Judgment, 1August 2011, paragraphs 455-456; the CAT also judged that no interest should be due on sums to be paid, though without providing any detailed justification (see paragraph 457).

[88] Ofcom, Draft Determination to resolve Disputes between BT and each of Opal and Sky about Local Loop Unbundling Charges (2009).

other SMP conditions, namely the requirement for LLU charges to be cost oriented, and to provide network access at fair and reasonable conditions.[89]

Against this, Openreach argued that it had *"complied with all relevant charge controls and regulatory obligations relating to the LLU services"*[90], and as such did not violate the price controls set by Ofcom. Openreach also stated that "*no material financial and/or competitive harm was suffered by Opal throughout the lapsed period.*"[91]

Ofcom accepted that any additional costs for Opal and Sky due to the incorrectly set price controls would largely be passed on to (and absorbed) by their customers rather than incurred by Opal and Sky themselves. Ofcom also noted that Charles Dunstone, CEO of Carphone Warehouse Group plc, had felt "*the MPF prices were in line with expectations and had no impact on the company's financial guidance*"[92], and that on 1 May 2009, Carphone Warehouse Group plc raised their prices for customers, which more that covered the increase in the MPF charges.[93]

Ofcom decided not to require Openreach to make any retrospective repayments to Opal or Sky, on the grounds that there would be very little benefit to consumers or competition. Ofcom decided that the "*unfairness*" to Openreach from ordering retrospective repayments outweighed any potential benefits to Opal or Sky and their respective customers.[94]

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[89] Ibid, paragprah 3.17. Specifically, Opal argued that a minimum requirement for meeting both conditions was not only that charges were set in compliance with the applicable price control, but that the price control was set correctly. Because the price control was not set correctly, Openreach's charges must have been in breach of these conditions. Sky simply argued that it would be "*unfair and unreasonable*" to allow Openreach to be allowed to keep the difference between the amount it charged and the maximum amount it would have been able to charge if the price control had been set correctly.

[90] Ibid. paragraph 3.18.

[91] Ibid. paragraph 3.14. Openreach also drew attention to the fact that "*TalkTalk Group (Opal's parent company) raised its own end-user prices three times during the lapsed period of the charge control …to an extent unrelated to their input prices.*"

[92] Ibid. paragraph 3.20.

[93] 'Preliminary Results for the year to March 2009', presentation dated 5 June 2009 presentation (http://phx.corporate-ir.net/External.File?item=UGFyZW50SUQ9Nzg0MnxDaGlsZElEPS0xfFR5cGU9Mw==&t=1; and contemporaneous internal Ofcom note of 5 June 2009 audio presentation by Charles Dunstone.

[94] Ofcom, Draft Determination to resolve Disputes between BT and each of Opal and Sky about Local Loop Unbundling Charges (2009), paragraphs 3.53 to 3.57.

Mobile termination rates

In March 2007, Ofcom determined MTRs for the period of 2007-2011. BT appealed Ofcom's decision to the CAT on grounds that the MTRs set were too high.[95] Specifically, issues arose around the inclusion of a network externality surcharge, and the treatment of spectrum costs.

The case was referred to the UK Competitin Commission and the Competition Commission found that Ofcom had erred in relation to the inclusion of a surcharge for network externalities, and its treatment of spectrum costs. The CAT then disposed of the appeal by remitting the decision to Ofcom and directing Ofcom reset the price controls with retrospective effect; given that more than two years had passed in a four year price control, the CAT argued that not backdating the revised termination rates would undermine the effectiveness of the appeals procedure.

The mobile operators subsequently challenged this decision in the Court of Appeal. The Court of Appeal upheld the challenge and ruled that the CAT had no power to direct Ofcom to backdate the charges.

Specifically, the Court of Appeal held that the CAT could not direct Ofcom to backdate a price control because it "*does not have power … to direct Ofcom to take action that Ofcom itself would not otherwise have power to take in relation to the decision under appeal*."

In relation to Ofcom's power to set price controls with retroactive effect, the Court held that Ofcom's power to amend SMP conditions as set out in the Telecommunications Act was "*to revoke or modify the conditions for the time being in force*". Asking whether this would include the power to modify a condition with retrospective effect, the Court held that *"[t]he power … to set conditions in the first place is indisputably a power to set them with prospective, not retrospective, effect. The purpose of the conditions is to regulate the future behaviour of undertakings with significant market power in markets where there is a lack of effective competition. This is made clear both by the EU directives that the 2003 Act implements and by the terms of the 2003 Act itself. … Recitals (25) and (27) of the Framework Directive are particularly striking: they refer in terms to the need for 'ex ante obligations' in order to ensure the development of a competitive market in markets where there are one or more undertakings with significant market power. The forward-looking nature of such obligations is also apparent from the terms of Article 13 of the Access Directive: for example, the reference to the imposition of obligations in situations where an operator 'might' act in a particular way.*

[95] British Telecommunications PLC v Office of Communications (Mobile Call Termination), Case 1085/3/3/07

The same message is conveyed, unsurprisingly, by the implementing legislation. The power under section 45(1) of the 2003 Act is to set conditions binding the persons to whom they are applied, and the evident intention is to bind them in respect of their future behaviour. Section 88 provides in subsection (1)(a) that Ofcom is not to set an SMP condition except where there is a relevant risk of adverse effects arising from price distortion, all of which is defined by subsection (3) by reference to the pricing behaviour that the dominant provider might adopt; and the references in subsection (1)(b) to promoting efficiency and promoting sustainable competition are likewise directed towards the future and not the past."[96]

While the issues of regulatory gaming and intentional delaying of proceedings were raised, alongside concerns about the impact of such a ruling on the perceived effectiveness of the appellate regime going forward, the Court of Appeal judged that the CAT should use its case management powers to speed up proceedings and address concerns about delaying tactics by the parties involved.

[96] [2010] EWCA Civ 391 , paragraphs 37 - 39.