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**eEurope Means Nothing Without eEntry:
Regulatory Harmonisation, Subsidiarity and the
Realisation of the Information Society**

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eEurope Means Nothing Without eEntry: Regulatory Harmonisation, Subsidiarity and the Realisation of the Information Society

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Abstract: Last year, the European Council set forth an ambitious political initiative: “eEurope, an Information Society for All.” eEurope will never be realised, however, unless sufficient competitive facilities-based entry occurs. One of the primary barriers to entry in Europe remains the lack of regulatory harmonisation among the various EU Member States. To mitigate this significant barrier, the European Union will be forced to push the limits of subsidiarity. In so doing, this paper does not argue that individual Member States’ NRAs should be abolished in favour of some single, pan-European über regulator. Quite to the contrary, this paper submits only that the European Community must undertake more of a leadership (and, by definition, an active oversight) role, rather than continue in its current role of distant legislator and data collection authority. For example, positive steps that the European Commission could take to bring greater regulatory harmony among the various Member States include, *inter alia*, (1) developing a standard cost model – complete with a uniform system of accounts – for *all* of Europe (including harmonised accounting safeguards for intra-firm transfer pricing); (2) establishing a cohesive and truly standard pan-European reference offer; and, perhaps most importantly, (3) working towards achieving real regulatory transparency within each of the various Member States. As this paper shows, government’s job – be it local, national, or in this case pan-European – is to *maximise consumer welfare*. Thus, eEurope is within our grasp – it only takes the political will to achieve it.

TABLE OF CONTENTS

I. Introduction – eEurope	2
II. The Importance of Entry.....	5
III. Understanding the “Entry Condition”	7
IV. Harmonisation, Subsidiarity and the Information Society – Creating Conditions for Advanced Facilities-Based Entry on a Pan-European Basis	11
A. Current Economic Environment in Europe.....	11

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B. Positive First Steps	12
C. Subsidiarity and the “Entry Condition”.....	14
V. How to Move the Process Forward Constructively	16
VI. Conclusion	19

I. Introduction – eEurope

Last year in December, the European Commission set forth an ambitious political initiative: “eEurope, an Information Society for All”.¹ According to the Commission, the key objectives of eEurope are:

- To bring every European citizen, home and school, as well as every business and administration, into the digital age and online;
- To create a digitally literate Europe supported by an entrepreneurial culture ready to finance and develop new ideas; and
- To ensure that the whole process is socially inclusive, builds consumer trust and strengthens social cohesion.²

At its meeting in Lisbon in March of this year, the European Council fully endorsed the Commission's initiative.

While the economic performance envisioned by eEurope is noble in its goals, eEurope will not materialise simply by mere proclamation or by creating cute little “Infotoons.”³ Instead, ***the realisation of eEurope requires the European Community to expend the political capital necessary to create conditions conducive for entry by new, advanced facilities-based providers on a pan-European basis.***

As explained below, realisation of the Information Society depends on significant investments of fixed and sunk costs. As such, ***realisation of eEurope will require policy-makers to understand both the economics of new facilities-based entry, and how their regulatory polices directly affect the entry decisions (and, indeed ability) of firms.***⁴ Once the entry condition is understood, then policy-makers can turn to the

¹ http://europa.eu.int/comm/information_society/eeurope/pdf/com081299_en.pdf (hereinafter “eEurope”).

² *Id.* at p.2.

³ <http://www.maths.glam.ac.uk/itm/world.html>

⁴ *C.f.*, *Do the FCC Policies Promote or Deter Entry? That is the ONLY Question*, PHOENIX CENTER POLICY PAPER SERIES NO. 6 (October 1999) (<http://www.phoenix-center.org/pcpp/pcpp6.doc>).

concrete tasks of: (a) identifying optional long-term market structure; and then (b) determining the appropriate types of price, conduct and/or structural regulation that will achieve this goal.⁵ Without affirmatively promoting new, advanced facilities-based entry as Europe liberalises its markets, however, Europe is in real danger of creating a market characterised by mere “light handed” regulation over dominant incumbents who have both the ability and the incentive to harm European consumer welfare.⁶

⁵ Indeed, without specifying such a goal, how will policy makers be able to determine accurately what regulation to apply in the first instance and, moreover, how will policy-makers know when it is appropriate to remove its regulation (i.e., truly “deregulate”) once this goal (i.e. competition and the Information Society) is realised? Regulation has both costs and benefits, and poorly tailored or outdated regulatory policies may, in fact, do more to harm consumer welfare in the long-run than the public interest benefits the regulations were originally designed to achieve. *Id.* See also, F.M. Scherer & David Ross, *INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE* (3d ed. 1990); Oliver Williamson, *THE ECONOMIC INSTITUTIONS OF CAPITALISM* (Free Press 1985).

⁶ Take, for example, the failed U.S. experiment at telecoms restructuring. Despite its bravado, in the nearly five years since the passage of the 1996 Telecommunications Act, the FCC’s most recent numbers reveal that the amount of lines leased to competitors by incumbents “remained a small 0.4% of total ILEC lines – about 0.7 million lines as of June 30, 1999.” This report also indicated that in states such as Idaho, South Dakota and Wyoming, *no lines* (i.e., zero) were provided under UNE arrangements. See, e.g., *Trends in Telephone Service* (March 2000), Industry Analysis Division, Common Carrier Bureau, Federal Communications Commission at 9-3, http://www.fcc.gov/Bureaus/Common_Carrier/Reports/FCC-State_Link/trends.html. Resale does not fare much better. According to this same report, the rate of increase of resold ILEC services has slowed, no doubt as the result of the FCC’s pricing policies. (According to the Report: the 17% increase during the first six months of 1999 compares to a 25% increase during the last six months of 1998 and a 40% increase during the first six months of 1998. *Id.* at 9-2.) Moreover, although the FCC does not receive from CLECs data on the number of customer lines they provide solely over their own facilities or data about the types of customers they serve over their own facilities or by means of leased UNE loops, the FCC found that most CLECs had more success reselling specialized services, such as special access and local private line services, than they have had selling basic switched local service to end users. (*Id.* at 9-1.) In other words, they bleed red ink.

The “parade of horrors” does end there, unfortunately. The FCC has also made entry more difficult by, *inter alia*, (1) permitting the near total horizontal reconcentration of the incumbent telephone, cable and radio industries; (2) permitting the pre-mature re-vertical integration of the local and long-distance markets; and (3) instigating a “telecoms trade war” in everything from universal service to spectrum policy to undersea cable landing petitions. Instead, rather than have tangible competition and deregulation, the FCC instead improperly engaged in cynical and Faustian political backroom deals with industry just to produce ostensibly “lower prices” and “more choices” to consumers as quickly as possible – long-term consequences be damned. See Mark Naftel and Lawrence J. Spiwak, *THE TELECOMS TRADE WAR: THE UNITED STATES, THE EUROPEAN UNION AND THE WTO* (Hart Publishing 2000).

A classic example of the FCC’s cynical efforts to just “settle everything away” can be found in the FCC’s recent approach to access charge reform. On 31 May 2000, the FCC proudly announced that it was going to reduce access charge fees paid by long-distance companies to local exchange carriers. See *In re Access Charge Reform*, ___ FCC Rcd ___ FCC 00-193 (rel. May 31, 2000). To make a complicated story short, the FCC accepted a backroom deal (a fact disdainfully noted by FCC Commissioner Harold Furchtgott-Roth) offered up by certain industry participants – i.e., the “Coalition for Affordable Local and Long Distance Service” or “CALLS” – whereby in exchange for eliminating multiple access charges paid by

(Footnote Continued. . . .)

Unfortunately, as the European Commission often concedes, perhaps one of the greatest impediments to the realisation of the Information Society is the wide disparagement among Member States in liberalising their respective telecoms sectors, because ***the lack of regulatory harmonisation acts as a significant barrier to entry for new, advanced facilities-based network investment.*** That is to say, although entry into a single market is certainly a difficult endeavour, ***if a firm contemplates a pan-European entry strategy, then – due to the admitted lack of regulatory harmonisation among the various Member States – this firm must also revisit these regulatory issues each and every time it seeks to enter another Member State of the European Community. In other words – under current market conditions – as a firm seeks to expand across Europe and maximise its economies of scale and scope, the lack of regulatory harmonisation raises exponentially a new firm’s entry costs every time it must jump through each additional Member State’s National Regulatory Authority’s (“NRA’s”) regulatory hurdles.***

To its credit, the European Commission (EC) is proposing steps to bring greater regulatory harmonisation among the various Member States.⁷ Although such efforts are certainly welcome, however, ***given that some Member States were less than effective in implementing past EU directives and recommendations, what makes us so sure that the current round is going to be any different?*** Indeed, far too often have Member States sacrificed consumer welfare in the face of political pressure.⁸

As such, if pan-European entry is to occur, then the EC is also going to have to face squarely the politically contentious issue of subsidiarity in this process as well. If

consumers to long-distance companies, U.S. consumers would instead pay an increased flat monthly “subscriber line charge” (SLC) directly to the ILECs of \$4.35 per line ending up at \$6.50 per line in two years. While there may be *de minimis* relief for consumers, the reality is that long-distance companies are happy because it appears that their rates are declining (and therefore competitive against eventual RBOC entry into long-distance), and ILECs are happy because—considering the slow pace of residential competition in the United States—they have guaranteed themselves a steady revenue stream that is likely to continue for the foreseeable future. In this way, the FCC cynically has rid itself a thorny issue in a way that appears to lower residential user charges, but without materially hurting the incumbents’ stream of economic rents.

Such a cynical and political approach to such an important issue stands in stark contrast to the FCC of fifteen years ago, where these difficult issues were approached with solemnity and academic rigor. Indeed, if readers want to see what a constructive and well-reasoned and analytically honest access charge reform proposal should look like, then they should read the proposal set forth by former FCC Commissioner Anne P. Jones nearly twenty years ago. *In the Matter of MTS and WATS Market Structure*, CC Docket No. 78-72, Phase I, Third Report And Order, FCC 82-579, 93 F.C.C.2d 241 (1983), Separate Statement of Commissioner Anne P. Jones.

⁷ See *infra* Section IV.B.

⁸ See, e.g., Kevin J. Delaney, *France Government Withdraws an Amendment on Local Calls*, WALL STREET JOURNAL (27 April 2000) (reporting that the French government withdrew a legislative amendment that would have opened France Telecom to new competition via unbundling following a request by Communist Party leaders).

Europe had not decided to create a single market, then such regulatory failure would be a matter between each Member State and its respective citizens. However, **as Europe affirmatively decided by treaty to create a single market** (so much so that the European Community went so far as to make a unified offer in the WTO Agreement on Basic Telecoms Services), **regulatory failure is no longer is a domestic matter**. Instead, regulatory failure within one Member State affects directly the rapid creation of a pan-European market. Accordingly, this paper submits that **if individual Member States are unable or unwilling to join the European Community in working towards the goal of eEurope, then the European Union must also be prepared to push the principle of subsidiarity to its limits to facilitate investment in advanced pan-European broadband networks by new firms**.

Stating the issue bluntly, **the European Community – and, by extension, the European Commission – must take more of an aggressive leadership (and, by definition, an active oversight role) – instead of its current legislative and monitoring role – to the telecoms restructuring process other than just expecting that individual Member States will obediently correctly and expeditiously implement various EU Recommendations or Directives**. As explained below, this leadership can take many forms – e.g., leadership in establishing long-term restructuring goals; leadership in establishing cost models; and leadership in implementation. Under any scenario, however, if eEurope is ever to be realized, then the Community cannot continue to defer to “Member State’s rights” or to rely so heavily upon endless industry forums to resolve the complex issues facing the European telecoms sector.

Each issue is discussed specifically below.

II. The Importance of Entry

If the ostensible public policy goal of the European Community is to move from a market characterised by *monopoly* (i.e., *one firm*) to a market characterised by *competition* (i.e., *many firms*), then entry of *more* firms is the *sine qua non* of this entire exercise. More firms (i.e., facilities-based providers), however, is not the equivalent of more service “choices.” Indeed, if everybody is simply reselling the same service provided by the dominant incumbent, then the only competitive “choice” available to consumers is to whom they would like to write their monthly subscription checks out.

Similarly, simply because different access providers’ technologies are starting to “converge” (i.e., they are all starting to provide some sort of broadband Internet access) it does not *a fortiori* mean that consumers view these various access technology providers as *close substitutes*. Quite to the contrary, consumers may find that they view these various access technologies as *complements* instead – e.g., consumers may have local telephone provider; a cable provider, a mobile provider, and several Internet service providers. Thus, “convergence” does not automatically mean that various access technology providers have a measurable contestable effect on other firms in the market.

As leading one leading telecoms economist recently observed about the U.S. experience:

One explanation for the failure of the [1996 Telecoms] Act is that an important intermediate step between monopoly and competition has been overlooked. If consumers are to have a choice in local phone markets, the entry of new firms selling local telecommunications services to a broad base of residential and small business consumers is required. “Choice” in any context implies alternatives. *In fact, while the term “competition” has become somewhat synonymous with the Act, the Act is really much less about competition than it is about competitive entry.*⁹

Indeed, while there may be multiple firms “competing” against one another, *so long as these firms are scrambling to use the same underlying network facilities (e.g., the dominant incumbent local exchange carrier’s local loop), it does not a fortiori mean that “more” firms will produce “more” competition – i.e., better market performance as measured by lower prices or more services.* As such, any Directive or Recommendation from the European Commission:

*cannot force firms to compete, but can alter industry structure in such a way as to make entry profitable and, therefore, viable competition more likely. For example, legislation that reduces entry barriers can increase the number of firms in an industry, and the presence of many firms selling similar products and services will inevitably lead to price and quality competition. Without entry, however, competition in the local exchange market will remain nothing more than a fabrication of incumbent monopolists and their representatives.*¹⁰

Notwithstanding the above, however, it is also crucial for policy-makers to understand that competition is *not* a “zero sum game” (*i.e.*, the discredited notion that one firm can be made better off only by making another firm worse off”). Quite to the contrary, if eEurope is to be realised, then policy-makers must seek to “*grow the pie*” and not “*split the pie*” by removing entry barriers and reducing entry costs for new competitive advanced infrastructure wherever possible.¹¹

⁹ George S. Ford, *Opportunities for Local Exchange Competition Are Greatly Exaggerated*, ELECTRIC LIGHT & POWER (April 1998) at 20-21 (http://www.phoenix-center.org/library/ford_1.doc).

¹⁰ *Id.*

¹¹ A common objection raised by incumbent monopolists to new entry is that somehow competition will somehow lead to the construction of wasteful and duplicative facilities. Yet, at the same time, these same incumbents also resist mightily any effort to provide their competitors with access to their network. They cannot have it both ways.

III. Understanding the “Entry Condition”

As the European Commission has recognised often in the past, regulation has *both* costs and benefits. Accordingly, regardless of the merits of any rule or regulation imposed on the market, it does not *a fortiori* mean that European consumers suddenly will be awash in “waves” of competition. Entry is an extremely time and capital intensive endeavour,¹² and will only occur if the new entrant believes that entry will be *profitable*.¹³ A firm’s decision to enter any market can be described as the “Entry Condition” – *i.e.*, entry will only occur when:

- (1) Post-Entry Profit (**d**), *minus*
- (2) Inherent (exogenous) Entry Costs (**x**), *minus*
- (3) Incumbent or Regulation-Induced Entry Costs (endogenous) (**e**), *plus* any
- (4) Spillover Effects (**s**) (*i.e.*, when some firms can enter more cheaply than others can),

¹² To wit, the telecoms industry is characterized by *high fixed and sunk costs*. Such a characteristic tends to create the need for *economies of scale*. Moreover, policy-makers must also recognise that not all segments of a telephone network share the same economic characteristics and, therefore, fixed and sunk costs differ widely depending on a new firm’s particular entry strategy. Thus, despite the plethora of would-be pundits statements that we live in an era of infinite bandwidth, then why does it still cost so much in many places to terminate a call? (No matter how much we might like to ignore it, the telecoms business still boils down to the basic transaction of one party handing off traffic (data or voice) to another carrier and compensating each other (peering, “bill-and-keep,” settlements, *etc.*) for the service provided.) Moreover, if bandwidth is really so infinite, then would anyone bother to invest in new alternative advanced networks in the first instance?

Second, the telecoms industry is characterized by “*network externalities*” – that is, consumers value a product more as other consumers increasingly use the product. The effect of network externalities on the telecoms market cannot be understated. For example, the presence of network externalities tends to argue for *uniform technical standards, frequencies and interfaces*. Similarly, the presence of network externalities tends to lead firms to seek *economies of scope*. If eEurope is ever to materialise (*i.e.*, the ability to offer consumers a “seamless” European-wide service), therefore, then entry barriers for alternative infrastructure providers must be reduced *throughout* the Community.

¹³ Indeed, it is very important for policy-makers not to make the deployment of xDSL technologies in Europe the exclusive (although important) policy priority in this round of proposed rules, because a xDSL entry strategy is *just one of many different strategies* a firm might contemplate undertaking if local access is made available at technically feasible points in the PSTN. In fact, the concept of “local access” means far more than access to just “residential” customers. Instead, “local access” should be interpreted broadly to include access to all types of customers – SMEs, MDUs, office buildings, residential, and SOHOs, *etc.* Accordingly, what is important for policy-makers to understand is the effect of broadband technologies on the entry condition – that is, with its *higher revenue potential*, it makes facilities-based entry into residential markets *more profitable*, and therefore *more likely to occur*

(5) Are greater than **Zero**¹⁴

This maxim can be represented by the formula:

$$d - x - e + s > 0$$

Post entry profits might be (loosely) defined as revenues minus average cost (excluding amortised sunk costs). This margin must be sufficient to cover any sunk costs (x, e) the firm must incur upon entry (and, to possibly, exit). Sunk costs are akin to a non-refundable deposit, and as such substantially increase the risk of entry. Sunk costs can be either a results of the capital expenses for technology and marketing necessary to enter a market (exogenous sunk costs)¹⁵ or the result of incumbent behaviour and regulatory decisions (endogenous sunk costs).

One real-world example of an endogenous sunk cost is the cost of physical collocation in a dominant incumbent's central office/local exchange. That space can, because of regulation, only be used to provide telecommunications services – once procured, a new entrant cannot readily convert collocation space to a condo or a youth education centre. The incumbent knows this and, absent regulatory oversight, will rationally seek to price collocation in a manner akin to an “entry tax.”¹⁶

Accordingly, *virtually every decision*, past and present, the regulator makes alters one or more variables in the entry equation (with the exclusion, by assumption, of exogenous entry costs (x)).¹⁷ That is to say, if a firm is contemplating the construction of a new pan-European advanced network, what factors does regulation have a direct (or, at minimum indirect) effect on? Obviously, nearly *everything*. Among other things, the quintessential elements required to construct a new advanced telecoms network – but whose costs and availability are affected (directly or indirectly) by regulation – include *inter alia*:

- (1) Cost-based interconnection rates on a forward-looking basis (domestic and international) at any technically feasible point;

¹⁴ Ford, *supra* n. 9. *C.f.* Dan Roberts, *US Groups Drop UK Web Plans*, FINANCIAL TIMES (20 September 2000) (reporting that both WorldCom and Global Crossing abandoned their respective plans to introduce high-speed Internet access in the UK due to intolerable frustration at the lack of progress in Oftel's unbundling efforts).

¹⁵ In fact, as competition begins to take hold – because telecoms is a declining cost industry – the cost of *selling* the service can be expected to increase even as the cost of *providing* the service continues to decrease.

¹⁶ In the United States, these construction costs are, unfortunately, lightly and ineffectually regulated (if at all) and are oftentimes are in excess of \$100,000 for each central office. With that type of entry tax, it is not surprising that there has been little entry into smaller or rural central offices in the U.S.

¹⁷ For example, unchecked incumbent horizontal reconcentration and vertical re-integration can reduce spillover effects.

- (2) Effective OSS and standard technical interfaces;
- (3) Timely and adequate collocation;
- (4) Cost-based backhaul, IRUs, and leased lines on a forward-looking basis;
- (5) Access to rights of way, poles, ducts, *etc.*;
- (6) The ability to dig up streets without a hassle¹⁸;

¹⁸ To illustrate this point, compare the respective experiences of New Zealand versus the United States. When the New Zealand government decided to restructure its telecoms industry, they decided to do something radical. Fully aware of the dangers of regulatory capture, they adopted essentially a two-prong approach. First, New Zealand would mitigate the incumbent's residual market power by vigorous enforcement of existing competition law. Second, and more importantly, New Zealand decided to promote aggressively new entry by reducing, to the extent practicable, all regulatory barriers to entry. Among the most significant pro-entry policies are New Zealand's efforts to remove barriers to new facilities-based build-out. Indeed, rather than extort concessions from new entrants to build new advanced broadband networks (such as that found in the United States), in 1989 the Government introduced a special provision called "Network Operator Status" to provide new entrants the right to apply for a court order to install telecommunications plant on public and private property. Not only is it not a pre-requisite for conducting business as an end-to-end carrier, but also designation is automatic on application for those that qualify. Moreover, New Zealand – unlike the United States – has an open-door policy that encourages – rather than deters – foreign entry into the market as well.

As a result of this pro-investment climate, numerous foreign firms have entered significantly into the New Zealand market. For example, British Telecom has invested NZ \$160 million and Vodafone has invested NZ \$200 million in advanced technologies. But, perhaps most encouraging of all, Saturn and Telstra (the dominant firm in Australia) have recently announced their investment of more than NZ \$1 billion dollars in a broadband network which will *pass over two thirds of all homes* in New Zealand.

The significance of the Telstra/Saturn investment in particular cannot be overstated. First, the Telstra/Saturn investment again demonstrates that competition – rather than regulation – has a significant impact on the price for local telephone services. The Wellington region has experienced a significant decrease in price as a result of competition, and the rollout of the remainder of the network will no doubt put downward pressure on overall prices. Indeed, as the Ministry of Commerce noted late last year, OECD figures show that the "relative performance [of the New Zealand residential telecommunications market] is considerably better than the OECD average." (New Zealand Minister of Telecommunications, Telecommunications Services Regulatory Regime (9 December 1999) at ¶ 22.)

Now contrast this performance with that found in the United States, where local call prices are actually on the rise due to the imposition of fees on consumers' bills such as a "subscriber line charge" and a "universal connectivity charge" and there is no competitive pressure from rival infrastructure providers. Why, because local governments continue to raise entry costs for new firms to build advanced facilities-based networks. See, e.g., Lyndsey Layton, *D.C. to Charge Cable Firms for Street Damage*, WASHINGTON POST (22 March 2000) at B01 (reporting that in response to disruptions of the city's roadways, Washington, D.C. would impose fees ranging from [U.S.] \$ 739 to \$2,059 *per mile*); Lyndsey Layton, *Hidden Cost of Road Tear-ups*, WASHINGTON POST (16 March 2000) at A1 (reporting that Prince George's County Maryland imposed a franchise fee of 5% of a company's revenue for digging up the street to lay new cable).

- (7) Building access/inside wiring;
- (8) Non-discriminatory call origination for Internet access;
- (9) Number portability or, more accurately, number termination flexibility¹⁹; and, *depending on a firm's particular entry strategy*,
- (10) Non-discriminatory and cost-based access to unbundled cooper loops at any technically feasible point.²⁰

¹⁹ That is to say, it makes little sense to think about “number portability” from a demand-side perspective (*i.e.*, a consumer has a single number which follows him or her for the rest of their life) because nobody really cares how many telephone numbers they may have. (Plus, having one number permanently assigned to you raises a rather unsavoury Orwellian connotation as well). Instead, truly efficient number portability is *not* the ability for residential consumers to take one number with them from provider to provider, but instead *the ability for consumers to have one number that can route traffic to them wherever they are in world.*

²⁰ Like any other exactly regulation, mandating that dominant incumbent providers unbundled their networks must have a purpose aside from the vague notion that it would be a “good idea” or, worse yet, imposing unbundling simply because some other country may be imposing unbundling as well. Instead, unbundling *should be one of several tools* in the policy-makers arsenal of pro-entry policies that hopefully will lead eventually to facilities-based infrastructure competition (on either a wholesale or vertically-integrated basis). Once this demand is realised and facilities-based competition exists, however, mandatory asymmetrical unbundling should, in theory, no longer be necessary. In other words, because regulation has both costs and benefits, there should be an end-purpose to any government intervention into the market. Unbundling should not be used to create a “static, incumbent-centric perpetual resale model” where everyone purchases their primary input from a single monopoly provider.

This is not to say that some form of mandatory resale should continue in perpetuity, however. Resale serves many important functions in a market. For example, it provides an entry strategy for a firm who may seek to introduce new technologies into the market. In addition, a vibrant resale market also can keep the market in check by differentiating themselves with better customer service, *etc.*

So how does unbundling come into play to accelerate new entry? The idea behind unbundling is that because there are high entry barriers into the local access market, unbundling – *i.e.*, a weak form of divestiture – seeks to “leapfrog” those barriers to accelerate the pace of competition. In its most simplest form, unbundling is supposed to lead to new facilities-based competition by providing new entrants initially with the appearance of “ubiquity” and economies of scope necessary to enter a very costly business – *i.e.*, the entrant would first develop its customer base, and (because it has no desire to purchase its primary inputs of production from its rivals) would then build-out as conditions warrant. Such a strategy is often referred to as a “smart-build” approach. This is precisely what the FCC did in its 1980 *MTS/WATS Resale Decision* to great success for the U.S. long-distance market.

Unfortunately, however, given the huge sunk costs and risks associated with constructing a new, alternative residential access network, many firms will not (or cannot) afford the “smart-build” approach. What do we do now? Again, the answer is easy: Use unbundling to create sufficient new alternative “non-incumbent” demand such that an alternative distribution company (“ADCo”) will find wholesale entry economically attractive and will serve this consolidated demand.

To wit, assume *arguendo* that after a new firm performs its initial cost modelling, the numbers reveal that a new facilities-based entrant will need a 40% market share to survive. (In other words, the market is only capable of sustaining 2.5 firms.) That is to say, there exist an equilibrium number of firms in an
(Footnote Continued. . .)

And, as if the preceding list is not large enough, regulators can, and often do, control post-entry profits (d) (revenue minus variable cost) through regulation. (Indeed phone rates and collocation prices, loop prices, USF/USO taxes, *etc.* are all direct controls over (d)). Thus, if regulators fail to get their pricing policies right in the first instance, then any contemplated entry decision by a new firm might just become a “non-starter.”

IV. Harmonisation, Subsidiarity and the Information Society – Creating Conditions for Advanced Facilities-Based Entry on a Pan-European Basis

A. Current Economic Environment in Europe

The “Entry Condition” outlined above provides a useful way of framing how regulation affects the costs of business decisions. In real life, however, entry decisions involve intangible factors other than a cash-flow positive projected balance sheet. In the case of eEurope, perhaps the biggest intangible is whether European citizens even really want the Information Society to be realised. Indeed, as the European Council

industry (N^*). This equilibrium number of firms depends on: (1) The size of the market in expenditures (+); (2) The size and nature of production cost (-); and (3) The intensity of price competition (-). This can be represented as:

$$N^* = \frac{1}{\text{Minimum Market Share}}$$

Thus, *the larger are economies of scale and sunk costs, the larger is the market share required to justify entry.* In the case of telecoms, the minimum market share for a facilities-based local provider of mass market local service is large, suggesting high concentration in that market – i.e., facilities based entrant for mass market will require large market share (20 - 50%). The telecoms market therefore stands, for example, in contrast to the market for fast food or “take away” restaurants (*e.g.*, McDonalds) where in any given city, you see numerous burger-joints all within one square mile of each other because they need a *de minimis* market share to survive. (*C.f.* John Sutton, *SUNK COST AND MARKET STRUCTURE* (MIT Press 1991).)

Thus, given the huge costs of entering the local access business, few firms would be willing to risk its capital for such an endeavour. However, who says that only one firm has to provide this entire market share by themselves? If unbundling is successful, then it is entirely possible for four firms to provide 10% of the market; 10 firms provide 4% of the market; 40 firms serve 1% of the market, *etc.* and then have an facilities-based carrier enter exclusively on a wholesale basis and consolidate and serve this new demand.

Accordingly, unbundling is supposed to be a two-stage process: (1) unbundle and stimulate new alternative, non-incumbent demand; and (2) have new facilities-based entry to serve this consolidated demand. Where the FCC’s current efforts fail, among other things, is their apparent belief that unbundling is sufficient, *in-and-of-itself*, to solve telecoms’ current ills and therefore they need also not do anything else affirmatively to promote additional facilities-based-entry. Wrong. So long as regulators do absolutely nothing to provide alternative mechanisms of delivery (especially as technology grows and develops), then consumers will suffer in the long-run with the current “static, incumbent-centric perpetual resale model” now in place because neither incumbents nor new entrants will have any incentive whatsoever to invest in new plant. For a fuller exegesis of this issue, see Naftel and Spiwak, *THE TELECOMS TRADE WAR*, *supra* n. 6.

conceded, Europe “must overcome the handicaps that are holding back the rapid uptake of digital technologies” including, *inter alia*, such basic economic conditions as:

- An “insufficient digitally literate on-line population”;
- The “lack of a sufficiently dynamic, entrepreneurial, service-oriented culture”; and, perhaps most important of all,
- A “public sector that is not playing a sufficiently active role in enabling the development of new applications and services.”²¹

In fact, privatisation in much of Europe is still a relatively new phenomenon, and several Member States still retain an equity stake in their indigenous incumbents as well.²² As such, we must remember that “privatisation” (*i.e.*, the conversion of a state-owned monopoly to a privately-held monopoly) is only *the first step* in the process. Achieving the most important and difficult part – *i.e.*, *the fundamental restructuring of the underlying market conditions to create an environment capable of sustaining competition* – still has a very long way to go.²³

B. *Positive First Steps*

Given the above, therefore, entry into a single market is certainly a difficult endeavour. When a firm contemplates a pan-European entry strategy, however, then due to the admitted lack of regulatory harmonisation among the various Member States, this firm must also revisit these regulatory issues each and every time it seeks to enter another Member State of the European Community. In other words – under current market conditions – as a firm seeks to expand across Europe and maximise its economies of scale and scope, ***the lack of regulatory harmonisation raises exponentially a new firm’s entry costs each time it must jump through each additional Member State’s NRA’s regulatory hurdles.***

Over the last several years, Europe has worked hard towards both liberalising and restructuring the European telecommunications market. Notwithstanding, as the European Commission concedes in its 1999 *Fifth Report on the Telecommunications*

²¹ eEurope, *supra* n. 1 at p 5.

²² In fact, the European Court of Justice recently found that Italy violated numerous provisions of the EC Treaty for attempting to give itself “special powers” to control the actions of Telecom Italia in order to block potential acquisitions by foreign entities. Case C-58/99, *Commission of the European Communities v. Italian Republic* (23 May 2000).

²³ “Entrepreneurship” – defined by the dictionary those people who are willing both to organize a business venture *and to assume the risk for it* – needs to be affirmatively encouraged and promoted by policy-makers, not ignored (or worse, effectively, albeit unintentionally, quashed). Thus, a *de facto* return to state-run monopolies is not an acceptable substitute for promoting the entry condition. Monopoly is still monopoly – regardless of ownership structure.

Regulatory Package,²⁴ there is – to state it politely – a wide disparagement of results across Europe. To wit, some Member States have high rates for interconnection, yet low rates for leased lines (Germany, France); yet, on the other hand, other Member States have low rates for interconnection, yet high rates for leased lines (United Kingdom; Sweden).²⁵ Accordingly, until there is effective harmonisation among the various Member States’ regulatory regimes, entry costs will remain unnecessarily prohibitive and the Information Society will remain an ephemeral dream.²⁶

So what should we do? For starters, on 12 July 2000, the European Commission proposed an aggressive set of five directives and one regulation that are intended to create a “new framework for regulation of electronic commerce.” They are:

- A draft directive on a common regulatory framework for electronic communications networks and services, which seeks to set out the horizontal provisions of the new electronic communications regulatory framework of the European Union²⁷;
- A draft directive on the authorisation of electronic communications networks and services, which aims to reduce entry costs by harmonising the rules for authorising provision of electronic communications services²⁸;
- A draft directive on access to, and interconnection of, electronic communications networks and associated facilities, which seeks to establish a framework for access and interconnection agreements across the EU²⁹;
- A draft directive on universal service and users’ rights relating to electronic communications networks and services, which seeks to set out the rights that users have in respect of electronic

²⁴ http://europa.eu.int/comm/information_society/policy/telecom/5threport/index_en.htm

²⁵ Communication from the Commission to the European Parliament, the Council, the Economic and Social Committee and the Committee of the Regions, Fifth Report on the Implementation of the Telecommunications Regulatory Package (11 November 1999) (hereinafter “*Fifth Report*”), Annex 4-4; Annex 4-6. (http://europa.eu.int/comm/information_society/policy/telecom/5threport/pdf/5threp99_en.pdf).

²⁶ As the European Commission itself concedes, the “comparatively low level of harmonisation in particular of the Community licensing and interconnection regimes represents a barrier to the single market” and the “wide divergences in the way in which Community rules are implemented at [the] national level raise further barriers.” See *Fifth Report*, *id.* at 2.

²⁷ http://europa.eu.int/comm/information_society/policy/framework/pdf/com2000393_en.pdf

²⁸ http://europa.eu.int/comm/information_society/policy/framework/pdf/com2000386_en.pdf

²⁹ http://europa.eu.int/comm/information_society/policy/framework/pdf/com2000384_en.pdf

communications services, in particular in respect of universal service³⁰;

- A draft directive on the processing of personal data and the protection of privacy in the electronic communications sector that seeks to update the current Directive to ensure it is technologically neutral and can cover new communications services³¹; and
- A draft regulation on unbundled access to the local loop, which introduces a requirement for local loop unbundling, designed to enter into force by 31 December 2000, in advance of the entry into force of the rest of the package.³²

Such proposed directives are indeed a very positive step towards increasing regulatory harmonisation in Europe. Notwithstanding the above, however, an important question springs immediately to mind – that is, ***if some Member States were less than effective in implementing past EC directives and recommendations, what makes us so sure that the current round is going to be any different?*** As such, if eEurope is to become a reality, then the EC is also going to have to face squarely the politically contentious issue of subsidiarity in this process as well.

C. *Subsidiarity and the “Entry Condition”:*

Under the principle of subsidiarity,

In areas which do not fall within its exclusive competence [e.g., telecoms], the Community shall take action, in accordance with the principle of subsidiarity, only if and in so far as the objectives of the proposed action cannot be sufficiently achieved by the Member States and can therefore, by reason of the scale or effects of the proposed action, be better achieved by the Community. [However, a]ny action

³⁰ http://europa.eu.int/comm/information_society/policy/framework/pdf/com2000392_en.pdf

³¹ http://europa.eu.int/comm/information_society/policy/framework/pdf/com2000385_en.pdf

³² http://europa.eu.int/comm/information_society/policy/framework/pdf/com2000394_en.pdf

The EC also issued a draft Directive dealing on a regulatory framework for radio spectrum policy in the Europe. http://europa.eu.int/comm/information_society/policy/framework/pdf/com2000407_en.pdf. Unfortunately, at the time of this writing, news reports indicate that political agendas are once again stymieing any chance of moving forward with a cohesive, pan-European unbundling paradigm. See, e.g., Dan Roberts and Fiona Harvey, *Move to Dilute EU Legislation*, FINANCIAL TIMES (26 September 2000).

by the Community shall not go beyond what is necessary to achieve the objectives of this Treaty.³³

Notwithstanding the above,

Subsidiarity is a dynamic concept and should be applied in the light of the objectives set out in the Treaty. It allows Community action within the limits of its powers to be expanded where circumstances so require, and conversely, to be restricted or discontinued where it is no longer justified.³⁴

Subsidiarity, when properly applied, can be a very efficient way to address complex issues of telecoms restructuring. Europe is far from homogeneous – culturally, demographically, geographically and economically – and therefore attempting to impose a “one size fits all” approach simply makes no sense. (To wit, the basic economic conditions of Sweden are quite different from the basic economic conditions of Greece.) As such, there are several important areas where local regulation by NRA’s can be far more effective than pan-European enforcement by the Competition Directorate or the Information Society Directorate who sit too far away from the fray to do much immediate good. For example, individual NRAs are well suited to:

- Resolving issues of universal service given the unique circumstances of their respective Member State;
- Determining the indigenous incumbent’s underlying costs in order to determine appropriate rates and charges for interconnection, access to local exchanges, *etc.*;
- Resolving interconnection disputes; and
- Working with local authorities to remove such entry barriers as local franchising expenses such as obtaining necessary permits, construction fees, easements, and the like.

This being said, as argued above, just because there are different economic conditions across the continent of Europe (just as there are across the 50 United States), so long as individual Member States perceive they have wide latitude to interpret Recommendations and implement Directives and Regulations, then by definition – as the EC’s own *Fifth Report* bears out – there will inevitably continue to be a sufficient

³³ Treaty Establishing the European Community, Art. 5.

³⁴ Protocol annexed to the Treaty of the European Community – Protocol on the application of the principles of subsidiarity and proportionality, O.J. C 340 (10 November 1997) p. 105 at ¶ 3.

amount of differences among the various Member States (either from legitimate economic theoretical or empirical differences, regulatory ineptitude, regulatory capture, or just plain old nationalistic petulance) to raise the entry costs of new firms.³⁵ As such, ***given that the Member States have agreed specifically by treaty to join a common economic framework***, then the EC must find a better way to ensure prompt and effective implementation of European Community economic development policies.³⁶ ***The issue, therefore, is really nothing more than a question of European Community political will – i.e., how serious are we really in achieving the Information Society?***

V. How to Move the Process Forward Constructively

Nothing in this paper should be read to stand for the proposition that all Member Country NRAs should be abolished in favour of some single, pan-European über regulator. What this paper *does* argue for, however, is to have the European Community to step up to the plate and deliver on their promise of eEurope. ***Stating the issue bluntly, the European Community – and, by extension, the European Commission – must take more of an aggressive leadership and oversight role – instead of its current legislative and monitoring role – to the telecoms restructuring process other than just expecting that individual Member States will obediently correctly and***

³⁵ See, e.g., *Fifth Report* at pp. 10-11, where the European Commission presents a virtual laundry list of regulatory failures across the Community including, but certainly not limited to, the lack of regulatory independence due to a Member State having an equity share in the indigenous dominant incumbent; NRAs that refuse to enforce aggressively the powers they have; NRAs who are more interested in social engineering rather than efficient economic outcomes; NRAs who lack sufficient powers; NRA's who are prone to regulatory delay; and an overall lack of resources and qualified staff.

³⁶ While DG IV does an excellent job at enforcing European Competition law, policy-makers must understand ***that competition law is not designed to act as a substitute for developing and implementing a cohesive restructuring policy paradigm***. Instead, it is supposed to act as a specific measure to enjoin individual instances of anticompetitive conduct, and not to undertake and implement a vision of long-term industry structure. Indeed, although both economic regulation and competition law should fulfil identical public-policy goals (*i.e.*, low and economically efficient prices, innovation, and efficient production methods), economic regulation and competition law approach and analyse market performance from different perspectives—*i.e.*, economic regulation seeks to promote competitive rivalry directly through rules and regulations while competition law enforcement seeks to foster competitive rivalry “indirectly by promoting and preserving a process that tends to bring them about. See, e.g., *Town of Concord v. Boston Edison Co.*, 915 F.2d 17, 22 (1st Cir. 1990) (Breyer, J.), *cert. denied*, 499 U.S. 931 (1991); *accord* *United States v. FCC*, 652 F.2d 72, 88 (D.C. Cir. 1980) (“basic goal of direct governmental regulation through administrative bodies and the goal of indirect governmental regulation in the form of antitrust law is the same—to achieve the most efficient allocation of resources possible”); see also *Antitrust, the “Public Interest” and Competition Policy: The Search for Meaningful Definitions in a Sea of Analytical Rhetoric*, ANTITRUST REPORT (Matthew Bender, December 1997) (http://www.phoenix-center.org/library/neo_comp.doc) and citations therein. ***Accordingly, as much as it is important for DG IV to keep up its excellent work, it is also equally important for regulators to narrowly tailor sufficient price, conduct and structural regulation to mitigate a dominant firm’s ability and incentive to engage in strategic anticompetitive conduct against its rivals.***

expeditiously implement various EU Recommendations or Directives or Regulations.³⁷ The Community cannot continue to defer to “Member State’s rights” or to rely so heavily upon endless industry forums to resolve the complex issues facing the European telecoms sector.³⁸ If the European Community has the political courage to think “outside the box,” then many positive contributions can be made to the regulatory harmonisation process – and, by definition, to accelerating entry and the realisation of the Information Society – within the confines of European Community law.

For example, a constructive first step would be for the European Community to provide greater leadership in the area of price regulation. To wit, the **European Community should develop a standard cost model – complete with a uniform system of accounts – for all of Europe.** In this way, each individual NRA could then plug in the relevant costs for its respective country and Europe can move beyond the current country-by-country disputes of even just how to calculate LIRC.³⁹ Similarly, **the European Community should also develop harmonised accounting safeguards for intra-firm transfer pricing** – especially now that competition is becoming increasingly “multi-dimensional” as firms vertically integrate various products and services.⁴⁰ Merely issuing a vague “laundry list” of items, such as found in the various Annexes to the 1997 Interconnection Directive,⁴¹ simply will not do the trick.

³⁷ What is so puzzling to an outside observer is to compare and contrast Europe’s reticence towards a cohesive pan-continent view towards fixed line restructuring with Europe’s incredibly successful – and, more importantly, *unified* – approach towards the mobile industry. Working like a true economic community, Europe resolved thorny issues of frequency, technical standards and the like on a pan-European basis. See, e.g., Council Recommendation of 25 June 1987 on the Coordinated Introduction of Public Pan-European Cellular Digital Land-Based Mobile Communications in the Community, Official Journal L 196, 17/07/1987 p. 0081-84. As a result, the market for mobile services in Europe is demonstrating good performance (phenomenal performance when compared to the US mobile market), as demonstrated by vigorous price and non-price competition, low switching costs among various providers, and – especially considering the astronomical sums spent in the various 3G auctions – new investment in infrastructure continues to increase. In fact, in a growing number of cases, European consumers are actually starting to view mobile as a close substitute for fixed line voice service.

³⁸ See, e.g., *Editorial comment: Endless Loop*, FINANCIAL TIMES (20 September 2000) (Commenting that a classic regulatory mistake in Europe was NRA’s erroneous belief that they could “leave the telecoms industry to decide arrangements for connecting broadband competitors’ equipment to [the incumbent’s] network. [Yet as history] can attest, there can be no such ‘market solution’ in the face of obstructionism by an incumbent monopoly determined to cling to traditional privileges: the regulator’s *raison d’etre* is to impose change, by force if necessary.”)

³⁹ Indeed, failing to set forth a standard cost model – complete with a uniform system of accounts – was perhaps one of the bigger mistakes of the FCC’s interconnection order. Instead, the FCC attempted to adopt a “one-size fits all approach” of approximate interconnection costs which, out of both principle and pride, state public service commissions felt obligated to ignore in favour of developing their own models of “forward-looking” costs. It is no wonder why local competition in the US is nascent at best.

⁴⁰ One of the common arguments raised by incumbents against using a uniform system of accounts is that they would be unduly burdened by having completely redo their accounting procedures (no doubt (Footnote Continued. . . .))

Second, **the EC should strive to achieve operational harmony among the various Member States.** For example, assume *arguendo* that a firm is contemplating constructing a pan-European advanced broadband network that links all of the major cities in the Community. As part of this business plan, the firm also wants to establish a call-centre somewhere in the south of France or in the Tuscany region of Italy. In order to operate this pan-European business efficiently (*i.e., profitably*), however, the controller in the call-centre needs to be able to use the same operational and technical protocol from Copenhagen to Athens. Thus, so long as Europe continues to have sufficient differences among the various Member States for technical standards and operational protocols, then transaction costs remain high and entry continues to be delayed if not outright deterred.

Third, although issues of interconnection are obviously best left to private contractual negotiations among the various parties, Europe has recognized correctly in the past that when it comes to telecoms, the respective bargaining power of each of the parties is quite skewed (*i.e., the incumbent has virtually 100%, and new entrants have nil.*) To remedy this situation, the European Commission again attempts to direct individual NRA's to develop a standard set of reference offers in the proposed Interconnection Directive⁴² and Unbundling Regulation.⁴³ While this general notion is a step in the right direction, exactly what guidepost does the European Commission provide to NRAs in this area? Again, just as with the complex issue of harmonising cost modelling in the Community, the EC again only provides the NRAs with yet another vague "laundry list" of topics based upon Annex VII of the Interconnection Directive which the European Council only "encourages" Member State NRAs to include in standard reference offers and interconnection agreements. As such, if individual NRAs have no common guidepost from which they may all begin, then

at great cost) in order to comply with such a regulation. Hardly. Nearly every publicly-held company has more than one set of books in order to deal with various business exigencies – *i.e., a set of books for internal cost allocation; another set of books for the tax collector; and a completely different set of books for the stock analysts. One more set of books is not going to break the bank.*

⁴¹ Directive 97/33/EC of the European Parliament and of the Council of 30 June 1997 on interconnection in telecommunications ensuring universal service and interoperability through application of the principles on open network provision (ONP), art. 4(3), [1997] OJ L199/32.

⁴² According to Article 9 of the proposed Interconnection Directives, the Community only states that "where an undertaking has obligations in the area of non-discrimination, national regulatory authorities shall be able to require the undertaking to publish a Reference Offer, sufficiently unbundled, giving a description of the relevant offerings broken down into components according to market needs, and the associated terms and conditions including prices."

⁴³ According to Article 3.3 of the proposed unbundling regulation, the European Council only provides that notified "operators shall publish, by 31 December 2000, a reference offer for the unbundled access to the local loops and associated facilities including collocation, sufficiently unbundled, and containing a description of the component offerings and the associated terms and conditions, including prices. . . ."

how can the EC rationally expect these NRAs to formulate any form of cohesive and harmonised policy? Obviously, they cannot.

Accordingly, more is required in this area. If eEurope is to be realised, then **the European Union should establish a cohesive and truly standard pan-European reference offer that parties can use in their individual negotiations.** After all, the more protracted the negotiations, the more pan-European entry is deterred or outright denied. And, if a dominant incumbent perceives that it can make one Euro more by deterrence than it can by competition, then the incumbent – as a profit-maximising firm – will *always* choose deterrence.

Given the rapid pace of technological change in telecoms, the importance of establishing a cohesive and truly standard pan-European reference offer cannot be overstated. For example, without a standard pan-European reference offer, new entrants will effectively be deterred from constructing networks where the most efficient design might be to place the physical switch outside of one country's borders and haul the traffic into another's. Similarly, as IP interconnection technology is deployed across the Community, the lack of a standard pan-European reference offer will further delay or deter competitive entry as it will permit dominant incumbents to dictate the routing of data and IP traffic right at the source without any opportunity for competitive facilities-based competition.

Finally, but perhaps most importantly, **the European Community must work towards achieving real regulatory transparency within each of the various Member States.** As noted above, the European Commission found in its own *Fifth Report* that the amount of conflicts of interest between NRA's and state-controlled incumbent carriers – as well as outright naked regulatory capture – was staggering. Until the European Community develops meaningful ways to ensure meaningful regulatory transparency – for example, developing a standard “code of conduct” for regulators (applicable to both NRA and European Commission staffers alike) or, more preferably, some sort of pan-European administrative procedures legislation – European telecoms policy will continue to be formed in large part via *ex parte* “backroom deals” with little or no opportunity for public notice and comment – a result which runs inapposite to the egalitarian goals of eEurope. (To wit, if one side makes an *ex parte* contact with a NRA or European Commission staffer, due process and fairness requires the other side to know when this contact took place, and the contents of the presentations made therein.)

VI. Conclusion

In sum, the issues touched upon in this paper are only the tips of the iceberg. As such, this paper does not attempt to critique any of the specific methodological issues raised by the EC's proposed Directives and Regulation, but seeks instead to attempt to highlight the two macro procedural prerequisites to the realisation of the Information Society: (1) the entry of new, advanced network service providers, and (2) the political courage and resolution to create conditions conducive for this new entry to occur.

Indeed, if eEurope is ever to become more than just political rhetoric, then European Community must aggressively take steps to encourage new facilities-based entry. If this means pushing the boundaries of subsidiarity with recalcitrant National Regulatory Authorities, then so be it. Perhaps U.S. Judge Frank Easterbrook summed it up best over ten years ago.

The principle that regulation must extend to catch all substitutions at the margin has a corollary: *if you're not prepared to regulate thoroughly, don't start.*⁴⁴

Government's job – be it local, national, or in this case pan-European – is to *maximise consumer welfare*. eEurope is within our grasp. It only takes the political will to achieve it.

⁴⁴ Frank Easterbrook, *The Court and the Economic System*, 98 HARV. L. REV. 4, 39 (1984) at 40 (emphasis supplied).