Financial penalties consultation

Observations on Frontier Economics' response to Oxera's methodology for calculating penalties

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1 Introduction

The Commission for Communications Regulation (ComReg) has overarching functions and objectives to promote competition, promote consumer choice, and remove obstacles to the development of communications infrastructure.

In the case of electronic communications in Ireland, providers that have significant market power (SMP) within markets are subject to specific regulatory obligations. These are 'ex ante' obligations in the sense that they are upfront requirements to be fulfilled by *certain* providers of electronic communications that have been found to have SMP.

In Ireland, where a provider of electronic communications services that has been designated as having SMP at the wholesale level also operates at the downstream retail level, it must provide wholesale inputs to other operators (Other Authorised Operators, OAOs) in a way that does not impede the competitive process or harm consumers. Under the Access Regulations,[1] these obligations include those relating to access, non-discrimination and transparency.[2]

The SMP designations, and the wholesale obligations that follow, are designed to deter SMP providers from engaging in conduct that hinders the competitive process. Importantly, such breaches may or may not directly harm OAOs or consumers (including in a way that can be readily quantified). Rather, breaches of the rules will, depending on their severity, harm this 'competition-friendly' market environment, contrary to ComReg's overarching functions and objectives.

ComReg is responsible for enforcing compliance with obligations that have been imposed under the Access Regulations.[3] Under the current legislative framework, if, following an investigation, ComReg finds that there has been a breach, it has civil enforcement powers to apply to the High Court to request the imposition of financial penalties, as well as to make a proposal about the amount of those penalties. Ultimately, the Court decides whether penalties should be levied and their magnitude, albeit taking into account ComReg's proposal on the appropriate amount.

In 2016, Oxera was asked by ComReg to explore whether a 'turnover-based' approach to setting penalties for breaches of ex ante wholesale obligations is appropriate. Oxera was asked to undertake additional research in 2019.

Oxera's final report was published in April 2020,[4] alongside ComReg's consultation.[5] We proposed two parallel approaches, dependent on the nature of the breach:

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[1] European Communities (Electronic Communications Networks and Services) (Access) Regulations 2011 (S.I. No. 334 of 2011). The Access Regulations transpose Directive 2002/19/EC of the European Parliament and of the Council of 7 March 2002 on access to, and interconnection of, electronic communications networks and associated facilities (as amended by Directive 2009/140/EC).
[2] Obligations may also relate to price control, cost accounting, or accounting separation requirements.
[3] European Communities (Electronic Communications Networks and Services) (Access) Regulations 2011 (S.I. No. 334 of 2011). The Access Regulations transpose Directive 2002/19/EC of the European Parliament and of the Council of 7 March 2002 on access to, and interconnection of, electronic communications networks and associated facilities (as amended by Directive 2009/140/EC).
[4] Oxera, (2020), 'Guidelines and Methodology on Financial Penalties in the context of the Access Regulations T07029' Prepared for Commission for Communications Regulation, Research report to support public consultation, April.
[5] ComReg, (2020) 'Calculating penalties for Access Regulations breaches', Consultation, Reference: ComReg 20/25, 9 April.

- a turnover-based approach;
- a tariff-based approach.

Frontier Economics (‘Frontier’) has undertaken a review of Oxera’s report, on behalf of eir.[6] This review formed part of eir’s response to the ComReg consultation.[7] Frontier raises a number of issues with the approach put forward and suggest various modifications. In what follows, we focus only on the main issues raised by Frontier. This should be read in combination with the final Oxera report, Frontier’s response to our report, and ComReg’s response to the consultation.

[6] Frontier Economics (2020), ‘Response to Comreg’s consultation on regulatory penalty methodology’, June.
[7] eir (2020), ‘Response to Comreg consultation. Calculation of penalties for Access Regulation breached. ComReg document 20/25’, June.

2 Review of the Frontier Economics response

We do not seek to address every point raised by Frontier in what follows. The fact that we do not cover every point raised by Frontier does not mean that we implicitly agree with Frontier on these points; instead, we focus on the *key* issues raised by Frontier, which can be grouped as follows:

- financial penalties are not the only option in addressing a breach of ex ante regulatory obligations;
- Oxera should take into account within its theoretical framework the benefits of cooperation during an investigation and the costs of disproportionate fines;
- Oxera's approach has given disproportionate low weight to assessing harm;
- Oxera is skewed towards the 'turnover-based' approach that it has proposed;
- Oxera provides insufficient detail on the workings of the 'tariff-based' approach;
- disproportionate weight is given to ex post competition cases in setting out the turnover approach and its parameters.

We cover each of these in turn below.

2.1 Financial penalties are not the only option in addressing a breach

In its response, Frontier makes two points:[8]

- in practice, as acknowledged by Oxera, regulators have a range of regulatory sanctions at their disposal, and Oxera does not propose any criteria to determine whether a penalty is appropriate;
- other regulators use a variety of measures to settle a breach with no financial penalty levied.

On the first point, it is correct that within our methodology we take as a given that ComReg, after having conducted its investigation, has concluded that a breach has occurred and that this warrants a penalty. We do note, however, that other sanctions may instead be appropriate. This would be for ComReg to determine.[9]

On the second issue—that of settlement—we do note in our report examples where, within the penalty methodology, there is an option for settlement.[10] We also note in our report that once a basic amount of a penalty has been determined, there could be adjustments, including 'reductions for settlement or inability to pay'.[11]

We did not focus in detail on the settlement issue, although it is part of our methodology. We note, however, that the regulators discussed by Frontier (Ofcom, ACM, Ofgem, Ofwat and ORR), which have determined in certain

[8] See Frontier (2020) Executive Summary, section 2.1 and section 4.3.
[9] Sanctions are limited to those in Regulation 19(4) of the Access Regulations: Financial sanctions; declaration of non-compliance; order to remedy non-compliance; order to become compliant. ComReg may also decide not to seek a penalty.
[10] Examples from Oxera (2020) in section 4 include: European Commission p. 26, Ofcom p. 46, Ofgem p. 51 and the Central Bank of Ireland p. 63.
[11] Oxera (2020), section 5.4, p. 87.

instances that no penalties should apply, all have powers to issue financial penalties for breaches of regulatory obligations *or* to secure binding undertakings in the absence of litigation, and to reduce penalties for early settlement. Under the current framework in Ireland, any such settlement agreements would be voluntary (as an output of litigation) and, while legally binding on the parties, any failure to comply with the undertakings would not be enforceable under the Access Regulations.

2.2 Benefits of cooperation and costs of disproportionate fines

Frontier discusses our theoretical framework, set out in section 3 of our report, which notes that financial penalties have two main objectives—punishment and deterrence. Frontier acknowledges this 'general theoretical framework is correct'.

However, Frontier notes that we do not discuss two further issues:

- the social and economic costs of 'high or disproportionate fines', including increased regulatory uncertainty, thereby raising the cost of capital and reducing the ability of a company to invest in its network;
- the 'economic benefits of cooperation with the regulatory investigation', in terms of reduced investigation costs and achieving earlier compliance.

On the first issue, the approach to turnover, duration and gravity takes into account proportionality (among other objectives). In section 3 of our report, we also noted that penalties should not be disproportionately high. In antitrust, for example, we stated 'setting a fine based on optimal deterrence may result in fines that are so high that they could be regarded as disproportionate'. We noted that 'most regimes apply a cap—as a percentage of total turnover—on penalties'. We adopt such an approach in our practical methodology, set out in later sections of our report (including section 5). We also discuss sector regulators where there are caps on penalties for breaches of ex ante regulations.[12]

Clearly, fines should not be so high as to compromise the functions of a network providing an essential service. While (in very simplified theory terms) the opportunity cost of capital is unaffected by regulatory fines,[13] excessive fines can push a company towards financial distress—which has its costs—while perceptions of regulatory risk can affect investor confidence. However, a company that engaged in repeat offending, thereby leaving itself exposed to repeat fines, could not be regarded as efficiently managed. Fines should not compromise the functions of an essential service, but they should be high enough to punish managers for their conduct, and ultimately shareholders for their lack of oversight, while deterring future breaches.

On the second issue, from a theoretical perspective, we do note in our methodology that lack of cooperation by a firm during an investigation may be due to behavioural biases.[14] The degree of cooperation with ComReg's

[12] See Oxera (2020). For example, section 4.4 provides UK examples and 4.6 provides Irish examples of where caps on penalties apply (expressed as a percentage of turnover).
[13] This is because the cost of capital is both forward-looking and dependent only on systematic risk (i.e., the risk of the utility concerned relative to the rest of the economy). As long as regulatory fines are not related in some way to the economic cycle, regulatory fines are idiosyncratic (investors can eliminate exposure to fines through portfolio diversification), and they are sunk costs to the business. Hence forward-looking investors will not demand an additional return on investment for exposure to regulatory fines.
[14] See Oxera (2020), section 3.3.4.

investigation is taken into account at the aggravating/mitigating factor stage of our practical framework.

2.3 Disproportionately low weight given to harm

Frontier argues that within the turnover-based approach, Oxera places disproportionately low weight on the assessment of harm. Frontier states that this is important to both assessing whether a fine is appropriate and, if so, what the level of the fine should be.[15]

First, Frontier states:[16]

> [best practice indicates] that the estimation/assessment of consumer harm is an important element of fining approaches. Our detailed review of the case studies used by Oxera for example, indicates that consumer harm was assessed in 15 out of 16 cases. Moreover, Irish law (Regulation 19(8)(d)) also requires a consideration to be given to “the effect on consumers, users and other operators”.

Second, Frontier asserts that Oxera’s methodology:[17]

> […] is based on a flawed and internally inconsistent premise that all breaches of ex ante regulatory obligations have a negative impact on downstream competition and therefore justify a penalty.

On the first point, concerning the 16 Oxera case studies, while regulators may take into account any specific evidence of harm in their approach to assessing whether a penalty is appropriate and, if so, at what amount, the extent to which this is a thorough quantified assessment has varied by regulator, and has also depended on the market context. Even where a regulator has found limited gains or harm, qualitatively or (in some cases) quantitatively, penalties have still been levied (by both ex post competition authorities and ex ante regulators).

Moreover, our approach *does not rule out* the assessment of harm as part of the analysis. Rather, we stated:[18]

> Ex ante regulatory obligations often go further than ex post competition law in the following key respects.
>
> - Regulatory obligations take a forward-looking view on potential market developments, and seek to address the risk of future harm.
> - In this vein, it is recognised that there is SMP at the wholesale level, which necessitates some form of ex ante regulation, for example including obligations for non-discrimination, transparency and/or access. It is the responsibility of providers with SMP in providing wholesale services to comply with these obligations.
> - It can be assumed that, in the absence of this compliance, there would be a negative impact on downstream retail competition, or a risk of such an impact in future.
> - In assessing breaches of ex ante regulatory obligations, therefore, the burden of proof should not necessarily be placed on the regulator to show cause and effect or downstream harm, in particular if a key objective is effective deterrence.

Thus, we do not say in our report that harm is not relevant to the assessment. Rather, the burden should not be on the regulator to prove direct quantified

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[15] Frontier (2020), Executive Summary, p. 6, and section 4.
[16] Frontier (2020), Executive Summary, p. 6, and section 4.
[17] Frontier (2020), section 4, p. 22.
[18] Oxera (2020), section 5.3, pp. 82–3.

harm in cases where there are breaches of ex ante wholesale obligations. To clarify, in an ex ante regulation setting, the regulator would need to confirm that the form of the conduct corresponded to the 'theory of harm' established when the ex ante SMP obligation was imposed. The regulator may then also consider any further specifics relating to the theory of harm in the particular case concerned; including a qualitative evaluation of the main impacts at the wholesale and retail level (who is harmed and who gains, directly and indirectly).[19]

We also noted in our report how UK regulators have levied penalties even in the absence of proven direct harm to customers or competitors. For example, in the case of a fine levied by Ofcom on BT:[20]

> BT argued that there was no financial harm to consumers, that it had not previously been in breach of regulatory obligations, and that the contravention was caused simply by delays in the process.
>
> **Ofcom's view was that limited weight should be placed on whether there was direct financial harm, as BT's contravention was 'intrinsically serious' by denying equivalence of access to relevant services.** Ofcom therefore sought a penalty to punish the contravention and to deter future non-compliance. It also took account of BT's compliance since the breach, and BT's past record of compliance with its various obligations. [Emphasis added]

UK and other European regulators are clear that breaches of ex ante regulations are serious and that a penalty can be levied even in the absence of proven direct quantified harm.

Frontier's proposed assessment of harm is based on an assumption that breaches of ex ante rules are only worthy of a penalty where they are found to have had a direct and measurable effect on non-SMP operators at the retail level.

Frontier's assumption is at odds with ex ante regulatory principles. Indeed, the principle of ex ante regulation is not to impose rules that directly *benefit* non-SMP operators (thus breaching would directly harm these operators). The purpose of ex ante wholesale SMP obligations (access, non-discrimination and transparency) is to encourage the process of sustainable retail competition on a forward-looking basis. Breaches of the rules will, depending on their severity, harm this 'competition-friendly' market environment. Such breaches may or may not directly harm operators (including in a way that can be readily quantified).

On the second point raised by Frontier—that Oxera's methodology is based on a flawed assumption that all breaches of ex ante regulatory obligations have a negative impact on downstream competition and so justify a penalty—the fact that the breach has been escalated to the penalty stage reflects an assessment by ComReg that there is potential harm to the competitive process. We discuss in our report that the mechanism through which harm is likely to occur dependent on its form should be identified. A range of gravity and turnover figures can be used, depending on the seriousness of the conduct and the affected segments.

[19] This issue has been clarified in our amended January 2021 report: Oxera, (2021), 'Guidelines and Methodology on Financial Penalties in the context of the Access Regulations T07029' Prepared for Commission for Communications Regulation, Research report to support public consultation, April 2020, amended January 2021.
[20] Oxera (2020), section 4, p. 45 (Box 4.10).

2.4 Skew towards the turnover-based approach

Our methodology involves the turnover-based approach being used for more serious breaches and the tariff-based approach being used for less serious breaches. Frontier argues that our report is skewed towards the turnover-based approach, and that the tariff-based approach should be the default approach.

In summary, Frontier argues that in choosing between the two approaches:[21]

> Oxera states in its report that aggravating and mitigating circumstances should be considered later in the case, when the basic penalty has already been calculated. This appears to be at odds with the regulatory precedents. Our review suggests that the regulators typically consider all relevant factors at the point when they establish whether a breach is serious. These factors include, among others:
>
> - whether the breach is perceived to be caused by deliberate or reckless behaviour;
> - whether this is a repeat offence; and
> - whether the operator has refused to cooperate with/obstructed the investigation.
>
> In our view, if a financial penalty has been considered appropriate it is only when a combination of significant consumer / competitor harm (i.e. 'millions of euro'), and significant aggravating circumstances listed above would justify imposing a penalty based on the entity's appropriate turnover. In all other cases where a financial penalty has been justified, **the default position should be a tariff-based approach**.

As we will discuss in section 3, we remain of the view that the turnover-based approach should be the main approach. The tariff-based approach should be reserved for specific types of less serious breaches.

Turning to the aggravating and mitigating factors listed by Frontier, which it states should be assessed at the start of the process, we would note that such factors may be taken into account in the early stages of ComReg's assessment of whether to set out a notification of non-compliance. However, Frontier's suggested amendment—to include this more explicitly upfront as part of the penalty determination—would either duplicate the existing process followed in advance of applying the methodology, or simply serve to hinder the process of penalty assessment.

Frontier argues that only 'very serious' breaches should be subject to the turnover-based approach, and that all others should be subject to the tariff-based approach. This decision would rely in turn on the calculation of harm.

Frontier argues that Oxera 'exaggerates' the difficulty in calculating harm to consumers or competitors, or the financial gains to the breaching party.[22] It recommends establishing an 'appropriate counterfactual', which would be compared to 'actual outcomes'. However, for the reasons outlined above, this would be difficult to calculate in the case of breaches of wholesale ex ante regulatory obligations. Such breaches may or may not affect individual OAOs over the shorter term, but the key issue is that they harm the process of competition over the longer term.

Frontier argues that Oxera has exaggerated the practical difficulties of estimating consumer or competitor harm. In support of this assertion, Frontier

[21] Frontier (2020), section 5.3, p. 31.
[22] Frontier (2020), section 5.2, p. 30.

makes reference to a paper in which 'Oxera has submitted detailed quantification of consumer harm on behalf of ComReg'.[23] The paper relates to another ComReg enforcement matter that is currently active. In that context it is not appropriate to discuss the details—except to point out that it concerns a breach by a *retail* provider, which affects consumers directly. It does not concern breaches of access obligations—by a provider with SMP at the *wholesale* level—to retail OAOs, which impede the competitive process.

As we made clear in our methodology report, and above, the ex ante theories of harm established at the time obligations are imposed are different for retail and wholesale breaches—as is the ease with which direct harm can be quantified. Direct consumer harm caused by breaches of obligations at the retail level, such as overcharging numerous consumers, may be more readily quantified. In contrast, the indirect long-term harm to the competitive process caused by a breach of wholesale obligations that will impact consumers in future is much more difficult to calculate. For breaches of obligations at the wholesale level, requiring harm to be calculated in each case would entail an undue burden of proof on the regulator and harm the objective of deterrence.

As discussed in our report, ComReg has various duties to promote the competitive space. The SMP designations and the wholesale obligations that follow are designed to deter SMP providers from engaging in conduct that hinders the competitive process. Such breaches may or may not directly harm OAOs (including in a way that can be readily quantified).

2.5 Tariff-based approach: lack of detail

While Frontier is generally in favour of the tariff-based approach, it notes that less guidance has been given on its application (compared to the turnover-based approach). It also suggests some specific amendments:[24]

> We recommend that a range of different weekly fixed fees should be considered to better capture differences in breaches (in terms of aggravating and mitigating circumstances and in terms of the materiality of the harm caused to consumers and competitors). In view of the fact that the €10,000 proposed by Oxera does not reflect the likelihood that some of the breaches could prove to have a relatively small consumer harm, it would seem appropriate to consider this as the maximum that could apply.

The tariff-based approach is not the main approach that we recommend. It is instead intended to capture less serious cases in which full application of the turnover-based approach—which we refer to as 'the general methodology'—would not be appropriate. As we note in our report:[25]

> Where there are less serious breaches of obligations imposed under the Access Regulations…, implementing the above general methodology and applying a pro forma approach to the duration of the breach (based on a percentage of the year's duration) may not be an appropriate solution—in that the general methodology should ideally be targeted at more serious breaches of SMP obligations in a vertically integrated setting.
>
> In addition, from an administrative perspective, the pro forma approach would be time-consuming to implement—it would require the assessment of theory of harm, relevant sales, gravity and other factors on a frequent basis.

[23] Frontier (2020), section 5.2.2, footnote 32, p. 30.
[24] Frontier (2020), Executive Summary, p. 9.
[25] Oxera (2020), section 6.3, pp. 97–8.

It is therefore inevitable that our report would contain less detail on the application of the tariff-based approach. It is inherently simple in nature. We state:[26]

> The tariff comprises fixed and variable components and is capped, and other aggravating (and/or mitigating) factors can also be taken into account. This approach is simple, proportionate, timely, administratively low-cost and effective for less serious breaches. This also provides more clarity for operators.

In contrast to Frontier's above assertion, set out in its Executive Summary, we did not provide illustrative figures for the individual components of the tariff (specifically, the €10,000). The figure reflects ComReg's position,[27] and this is indeed acknowledged elsewhere in Frontier's paper:[28]

> ComReg, in its consultation document, proposes the maximum cap to be set at €500,000. ComReg further proposes to set the fixed and weekly tariffs at €10,000.

Any tariff should ensure deterrence—in a similar vein to tariffs for speeding or parking violations. Frontier's insistence that such tariffs cause little harm, and that €10,000 should be an absolute maximum, would not provide the correct signal to SMP providers.

2.6 Turnover-based approach: disproportionate weight given to ex post competition cases

In justifying the turnover-based approach, Frontier claims that Oxera relies disproportionately on ex post competition cases (which it regards as inappropriate in assessing ex ante regulatory breaches).

We disagree that our proposed methodology approach is inappropriate. As we highlight in our report, for example:

- the approach recognises that breaches of ex ante regulatory obligations at the wholesale level are inherently serious, in that it is explicitly recognised that there is a need to promote a level playing field;
- the approach is transparent and practical to implement, using readily available data (for example, on turnover, duration, and benchmarks on gravity), even if a degree of judgement is necessarily involved;
- the approach is consistent with the EU rules on setting penalties for ex ante breaches in telecoms regulation (i.e. penalties should be appropriate, effective, proportionate, and dissuasive);
- there are many examples of a turnover-based approach being used in ex post competition law and ex ante regulatory settings, and turnover is often referred to as a relevant consideration in assessing penalties.

Turning then to the specific components of our turnover approach, Frontier argues that the ranges for gravity put forward in our report are inappropriate. Slightly different arguments are made in the Executive Summary and main text. In its Executive Summary, Frontier states:[29]

[26] Oxera (2020), section 7, p. 99.
[27] ComReg (2020), 'Calculating penalties for Access Regulations breaches Consultation', ComReg 20/25, April.
[28] Frontier (2020), section 7.1.1, p. 43.
[29] Frontier (2020), Executive Summary, p. 7.

> In relation to the degree of harm, Oxera's choice of "gravity factor" is 'anchored' on penalties relating to refusal to supply and margin squeeze cases (which are amongst the most serious ex post competition law breaches). Breaches of ex ante regulation are likely to result in significantly lower harm than the ex post competition breaches. Therefore, Oxera's choice of gravity factors is not justified.

In the main text, Frontier states:[30]

> We also note that Oxera's proposed gravity factor distribution relies on case studies of serious ex post competition breaches, where gravity factors are 10-15% of relevant turnover. Oxera then effectively "extrapolates" these numbers to significantly less serious and potentially immaterial breaches, assuming gravity factors of 10%, 5% and 2% depending on the case. These benchmarks are either anchored on precedents from an ex post competition cases, which is inappropriate for ex ante breaches (as discussed above), or otherwise extrapolated on an arbitrary basis.

As we discussed above, we disagree that breaches of ex ante wholesale regulations are less serious than breaches of ex post competition rules. We would also note that a degree of judgement is required, on a case-by-case basis, in arriving at appropriate gravity factors.

Frontier also argues that the probability of detection is higher in ex ante settings than in ex post competition cases, meaning that there is less need for deterrence in setting penalties (and so gravity factors should be lower):[31]

> In relation to the probability of detection, in view of a combination of the reporting obligations which ComReg has put in place, as well as eir's operation of a Regulatory Governance Model (RGM), the scrutiny of ComReg and access seekers, the probability of potential breaches of ex ante regulatory obligations being detected are expected to be high. This is in contrast, for example, with cartels where the probability of detection is generally considered to be relatively low - 10-20%. Therefore, the need for deterrence in the current regulatory framework is significantly lower than in ex post competition cases.

In our report, we discuss the issue of whether monitoring is more straightforward in an ex ante setting than ex post setting:[32]

> Due to the nature of the ex ante SMP regime, where an undertaking needs to be formally identified and designated with SMP, there are a limited number of undertakings that ComReg needs to monitor. In Ireland, these are eircom Limited and Raidió Teilifís Éireann (RTÉ), and the relevant fixed and mobile termination service providers.[33]
>
> In one sense, having this limited pool rather than all undertakings makes it easier for ComReg to monitor their activities and compliance with the obligations that ComReg has imposed.
>
> However, this should not be taken as a given. To establish whether a regulatory obligation has been breached, a regulator requires detailed information that can be provided only by the regulated entity. Even where the regulated entity fully co-operates and engages with the regulator, information asymmetry creates difficulties. Regulated entities may have ineffective internal governance provisions, meaning that sufficient evidence demonstrating compliance cannot be readily provided.

[30] Frontier (2020), section 6.3.2, p. 37.
[31] Frontier (2020), Executive Summary, p. 7.
[32] Oxera (2020), section 3.3.2, p. 19.
[33] See Commission for Communications Regulation (2020), 'Electronic Communications', https://www.comreg.ie/industry/electronic-communications/regulated-markets-competition/table-of-smp-obligations/, accessed 13 January 2021 for a list of SMP obligations that ComReg has imposed.

We also discussed the issue that 'larger regulated entities often have complex and divergent internal IT systems with multiple interlinked processes, which can make monitoring more difficult', and that 'regulated entities also may have more resources than regulators such that, even with governance models, regulatory reporting requirements and monitoring, detection problems may be very much present'.

Our report highlighted how, as a result of the settlement agreement entered into with ComReg in December 2018, Eircom agreed to implement the RGM. We stated:[34]

> Over the longer term, the RGM should improve ComReg's ability to monitor eircom's compliance with SMP obligations and to detect breaches. However, the RGM is in its infancy.

This increased ability to monitor over time may therefore have an impact, over the longer term, on the gravity factors selected.

Frontier notes:[35]

> We note that the maximum fine a UK regulator can impose is 10% of the regulated company's turnover in the relevant year. However, in practice penalties tend to be significantly lower than the threshold. In particular, Ofwat's penalty guidelines states that *'Although, we [Ofwat] have the power to set penalties of up to 10% of a company's turnover, in the past, where a substantial penalty has been imposed it has been* ***between 0.3% and 3.5% of the company's turnover****.'*[37]
>
> We also note that BIPT states in its penalty guidelines that fines should not exceed 5% of the offending party's total turnover.

Frontier further states:[36]

> Gravity factors in ex ante context should not exceed a maximum of 3-5% (in line with BIPT and Ofwat guidelines and precedents).

Frontier also states:[37]

> For a comparison, the 10-15% gravity factors recommended by Oxera contrast with a range of between 0.3% and 3.5% - 4.5% used by sector regulators (BIPT and Ofwat), where stated explicitly.

First, Frontier's statements are misleading and incorrect, as our recommended approach allows for lower gravity factors (as discussed above). In terms of comparing our approach to other regulators, penalties should also be considered in the round.

Ofwat considers the issue of which percentage of turnover figure to adopt and the relevant turnover figure to apply this to together. In previous Ofwat cases the (implied) gravity figures were applied to *whole-service* turnover (water service turnover, wastewater service turnover, wholesale water revenue or wholesale wastewater revenue). Working backwards, the implied gravity factors for *narrower* definitions of relevant sales would have been higher. In addition, Frontier ignores the 6.7% of turnover penalty that Ofwat was minded to apply to Southern Water, after the consideration of aggravating and mitigating factors.[38]

[34] Oxera (2020), section 3.3.2, p. 20.
[35] Frontier (2020), section 6.6.2, p. 42.
[36] Frontier (2020), section 6.3.2, p. 38.
[37] Frontier (2020), Executive Summary, p. 7.
[38] Oxera (2020), section 4.4.2, pp. 49–50.

Also ignored by Frontier is the fine levied by Ofcom on BT in 2017, which we discuss in our report.[39] This was for a breach of wholesale obligations to other providers. The £42m penalty included a 30% discount, applied as a result of BT accepting liability and entering into a voluntary settlement with Ofcom. In contrast, the provisional penalty figure was £60m. As a percentage of Alternative Interface leased lines revenues of £813m, the penalty was 7.4% (provisional) and 5.2% (post-settlement). An important objective of the penalty was deterrence.

As regards defining relevant turnover, Frontier refers to the Belgian regulator (BIPT) approach of using ‘niche turnover’ in 8 out of 11 cases or ‘the part of turnover that is directly relevant to customers affected by the infringement’.[40] However, all the cases listed by Frontier (in Annex D of its response) are retail breaches, whereby, for the reasons discussed above, the identification of which end-consumers are harmed and how is more straightforward. In contrast, wholesale breaches may or may not directly affect OAOs, but they impact the competitive process over the longer term.

As we note in our report, for wholesale breaches, there is the potential to adopt a wide or narrow definition of sales. An important reference point used by Ofcom in the finalisation of the BT fine (a wholesale breach), discussed above, was Alternative Interface leased lines revenues. Ofcom did not seek to drill down into the precise number of end-consumers affected in setting a deterrence-based fine.

[39] Oxera (2020), section 4.4.1, Box 4.11.
[40] Frontier (2020), section 6.2.3, p. 35.

3 Frontier's alternative approach: an assessment

3.1 Overarching observations

Frontier acknowledges the role of the turnover- and tariff-based approaches in assessing penalties for breaches of ex ante wholesale obligations. However, it proposes a 'number of steps that could be taken' to 'improve' the approach we have suggested.[41]

Frontier presents arguments around the steps followed, the order of this process, the burden of proof in assessing and quantifying harm, and the magnitude of the specific factors used. It proposes an alternative approach.[42]

However, the suggested changes would, in effect, design-in low, infrequent penalties. In turn, such penalties would be contrary to EU requirements that penalties should be appropriate, effective, proportionate, and dissuasive.

3.2 Step 1: is a financial penalty appropriate?

Frontier suggests that, as a first step, it would be necessary to assess whether a breach is 'likely to cause material consumer and/or competitor harm', in order to see if a penalty is justified. This step would not necessarily involve the quantification of harm. Aggravating/mitigating circumstances would also be taken into account at this stage.

We disagree. Such matters (including aggravating or mitigating factors, while not explicitly referred to as such), are considered by ComReg during case screening (which determines whether to open a case and assign resources), and in making a finding of non-compliance.

3.3 Step 2: a turnover- or tariff-based approach?

According to Frontier, the next step would be to assess whether the conduct falls under the tariff-based approach or turnover-based approach, which must be informed by detailed quantification of actual consumer or competitor harm relative to a counterfactual, with consideration also given to aggravating/mitigating circumstances.

Frontier argues that based on regulatory precedence, the turnover-based approach is only applicable to 'very serious breaches' causing 'significant harm' with 'aggravating circumstances'. In the absence of proving 'millions in damages to consumers', the tariff-based approach should be followed.

We disagree, as follows.

- While potentially relevant to the theory of harm in an ex ante setting, aggravating and mitigating factors are best considered at the end of the process, as modifiers to the basic amount using the turnover-based approach. This is standard practice across various regulators' approaches to penalty design.
- As discussed above, for breaches of wholesale obligations there may or may not be direct harm, which can be readily quantified, to an OAO. The harm is to the competitive process going forward. The burden of proof should not be on the regulator to prove direct quantified harm. Breaches of

[41] Frontier (2020), Executive Summary, p. 8.
[42] Detail is provided in the remainder of Frontier's Executive Summary and in sections 5 and 6, with summary recommendations provided in section 8.

ex ante SMP wholesale obligations are inherently serious in nature. Demonstrating quantified specific harm is not essential to setting a penalty based on a turnover-based approach. Regulators have explicitly stated that they do not need to undertake detailed quantification of harm in order to justify levying a penalty.

- As discussed in our report, sectoral regulators such as Ofcom, Ofwat, and Ofgem emphasise that turnover is a crucial benchmark to the fines that they levy across a range of cases (as regards seriousness). If a case is less serious or of lesser scope, then through the turnover-based approach it will have a lower gravity and lower relevant sales. Aggravating/mitigating circumstances can then be taken into account at a later stage, to modify the basic amount.

3.4 Step 2(ii): tariff-based approach

Frontier states that the tariff-based approach should be the default, and that a range of weekly fees should be considered, ‘to better capture differences in breaches (in terms of aggravating and mitigating circumstances and in terms of the materiality of the harm caused to consumers and competitors)’. In its view, the €10,000 figure should be regarded as a maximum.

We disagree. As discussed above, any tariff should be simple and ensure deterrence—in a similar vein to tariffs for speeding or parking violations. Frontier’s insistence that such tariffs cause little harm, and that €10,000 should be an absolute maximum, would not provide the correct signal to SMP providers of wholesale inputs.

3.5 Step 2(iii): turnover-based approach

If the turnover-based approach is followed, Frontier argues that several adjustments should be undertaken to our proposed methodology, which would lead to lower penalties: turnover should be specific to the sub-segments affected; gravity should not exceed the 3–5% typically used by regulators; duration should take into account delays in the process; and that a 10% overall proportionality check is too high.

While there is flexibility on the components of the turnover-based approach, we do not agree with Frontier.

- Turnover—regulatory precedence shows there is flexibility in defining relevant sales, but that adopting too narrow a definition should be avoided.
- Gravity—10–15% is an upper bound, and our recommendations were illustrative. Dependent on the case, gravity may be from 1–15% (and in practice is likely to be limited to a maximum of 10%). This should be left to the process on a case-by-case basis. In addition, the 3–5% range highlighted by Frontier was applicable to specific turnover measures (including sub-segments), so must be taken in context.
- Duration—this is to be determined on a case-by-case basis. Where this is of a transitory nature, the tariff-based approach may be more appropriate (for less serious breaches).
- Proportionality check—10% is a well-established standard limit across regulators. The appropriate limit in Ireland may be mandated in future legislation.

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