The Report of the Committee for Promotion of Competition in the Telecommunications Industry in Israel

Executive Summary

March 2008

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The communications sector is one of the most dynamic sectors of the economy, and is undoubtedly the most dynamic of the public utilities sectors in Israel. This dynamism has been nurtured by a constant flow of technological improvements, and it is reflected in the pace of implementation of these improvements, in the variety of services the sector offers, and in the changes in the public's demand for services.
This dynamism is surprising, considering the monopolistic origin of the sector and the government control of the sector until recently. The dramatic changes that occurred in the sector would not have been possible without the structural reforms implemented over the last 15 years. Opening the sector to competition was not a one-time event. The gradual nature of the process is reflected in differences in the competitiveness in the different sub-sectors. The degree of competition is influenced in no small part by the obstacles encountered by the structural reforms, as well as technological, institutional and economic constraints. As a result consumers in the different sub-sectors have not benefited equally from the fruits of competition, reduced rates and an improvement in the variety and quality of services.

On February 20th 2007, the Minister of Communications appointed a committee to advise him regarding the proper competition policy in those sub-sectors where competition is insufficient, to remove economic and technological bottlenecks, barriers to entry, and switching barriers, and to change the regulatory framework accordingly. This committee is the successor of a series of public committees which have assisted the Ministry of Communications in setting regulatory policy in the past. Following previous committees, this committee does not regard competition as an end unto itself; rather as a tool to improve consumer welfare, in the spirit of the committee's brief - "the provision of advanced telecommunications services, at reasonable prices, to the public in Israel". In this light the committee has reviewed the past regulatory policies, the development of the telecommunications sector over the last decade, the technological advances of the last years and developments expected in the near future, the legal framework that the regulation and enforcement is based on, and the international experience in the field of telecommunications regulation.

The standard indices for competitive achievement are the price level and the change in prices over time. The Israeli consumer enjoys an inexpensive basket of telecommunications services, compared to European and American consumers. The low prices of fixed telephony are especially noticeable, though the price of mobile services is also lower than the European average. The exception to this picture is in the field of multi-channel broadcasting. The price of the basic broadcast package in Israel is comparable to the highest in Europe.

The competitive picture is less encouraging when we consider the change in prices over time. The technological advances and the increasing efficiency are reflected in a continuing decrease in prices of price-controlled tariffs - calls within "Bezeq"'s fixed network - but they have not led, perhaps surprisingly, to a similar pattern in the non-controlled sectors. In these sectors, new entrants do lead to decreases in prices (sometimes drastic decreases), but as the new entrants become entrenched a pattern of price increases becomes apparent. This is observed in mobile telephony (mainly in the household sector), in international telephony and, in the multi-channel broadcasting sector. The initial price decreases in sectors that suffered from "inflated" prices in the monopolistic era, are reflected in prices that are still low by international comparison, but, as the international telephony sector shows, only the continued entry of additional competitors (even if their market share is low) leads to a continuing trend of price decreases.

Price levels and price changes are, however, only one aspect of competition. No less important in a sector buoyed by constant technological change, are improvements in the quality of services and the range of services offered to the consumer.

These improvements are determined, to a large degree, by the quality and the capacity of the infrastructure used to produce the services, and depend on the constant upgrading of these infrastructures. Thus, the competition in advanced services depends crucially on the competition between infrastructure owners. The lack of such competition in a critical subsection of the industry - fixed telecommunications - is at present one of the main points of weakness in the Israeli competitive structure. While the mobile sub-sector continues to provide a constant stream of new services, innovation in fixed services has stagnated. The sub-sector, which had been accustomed to a constant stream of investment over the last decade, placing it at the forefront of technology worldwide, faces a situation in which fixed services (most importantly, broadband), lag behind most Western countries. This lag in the supply of advanced services is in stark contrast to the dynamism evident in the demand for these services. The limited capacity of the fixed infrastructure prevents the provision of additional advanced, high-quality services. Specifically, it prevents the country-wide rollout of IPTV, thus preventing a solution to the high tariffs in the multi-channel broadcasting sector. The slowing of investment in the fixed sector affects not only consumers, but, and perhaps more importantly, affects the efficiency and innovation of the business sector, and could, in the long run, impact negatively the growth of the economy as a whole.

The high level of dependency of service providers on the infrastructures led Israeli policy makers in the 90's to adopt competition between independent infrastructure operators as the dominant model of competition. In this model the provider of services is also the infrastructure operator, and market entry requires an independent, nationwide network. In this model, the number of competitors is limited to the number of infrastructure, and investment in building an independent nationwide network establishes an insurmountable barrier to entry. This model has been strictly adhered to in the mobile sector. However, given the limited number of fixed network owners, it was decided in 2002 to widen the model, allowing entry to the fixed telephony sector of operators who would be allowed to offer a limited selection of products to a limited number of consumers, on a geographically limited basis, thus straying from the universality concept. Still, these operators were required operate on their own networks, or on leased network elements under their operational control. Similarly, in the multi-channel broadcasting sector, it was recommended that independent channel producers could operate on others' networks, though this recommendation was only partially implemented. Internet service providers have always operated on others' networks, and the international telephony operators purchased termination (or origination) services from the existing fixed and mobile networks.

This strict adherence to infrastructure-based competition led to the upgrading of the cable television network, and its conversion to telecommunications services, and placed Israel in the unique position of being one of a few countries worldwide with two universal fixed infrastructures. However, the slowdown in the upgrading of broadband networks points to the risks inherent in a duopoly situation in fixed infrastructures. In order to "thaw" this "freeze", we recommend implementing working to implement a solution that has been successful in many countries - creating a wholesale market, wherein service providers can lease or operate on others' infrastructures. New entrants have proven themselves to be the engines of competition in all sectors of the telecommunications industry. The only way to encourage competition in the fixed sector is to lower barriers to entry, by waiving the requirement that new entrants must own an independent access network.

European experience shows that the role of new entrants is not confined to price reductions, but they often become a stimulus of growth and investment. Telecommunications networks are normally not built of a single element. While the core network (the network that connects the local exchanges) has been adapted to carry large amounts of traffic and advanced services, the access network (which connects the local exchanges to the consumers) is of limited capacity. “Bezeq” is hesitant to upgrade the access network, claiming it to be unprofitable unless all regulatory restraints are removed. The committee considers the removal of regulatory restraints on “Bezeq” as a major deterrent of competition in the fixed sector, and a severe setback to competition in the telecommunications sector in general. European experience proves the vitality of a model where new providers, operating in a wholesale market, lease sections of the access network, upgrade them, and adapts them to the provision of the advanced services they offer. The supply of new services not only increases the welfare of the new operators' customers, but acts as a stimulant for the incumbents to upgrade the network as well, in order to compete effectively. Thus, the new entrants cause not only an increase in competition, but an increase in investment as well. A necessary condition for implementation of this model is the requirement that “Bezeq” lease elements of its local network (a similar solution is not, at present, technologically feasible regarding the cable network). The recommendation to require “Bezeq” to lease elements (LLU – local loop unbundling) is an important element in our recommendations to increase competition in the sector.

The recommendation to develop a wholesale market applies equally to other sectors of the telecommunications market. We recommend that the development of a wholesale market in the wireless sector should be speeded by Mobile Virtual Network Operators (MVNO), in the spirit of NERA’s recommendations and in accordance with a government decision. In accordance with the same principle, independent content providers should be given a real chance to operate on the multi-channel broadcasting infrastructure.

The establishment of a wholesale market involves, as does the development of any new market, some uncertainty. This uncertainty focuses on two factors: the number of new entrants that will make use of the new options, and the level of cooperation of the incumbent operators. Recent years have seen the creation of a number of corporate groups, each operating in numerous sub-sectors. A driving force for the creation of these groups has been the increasing consumer demand for “bundles” of telecommunications services (fixed calls, wireless calls, international calls, data services, internet, television, etc.). Convergence - the move of the different providers to the internet protocol language and the blurring of borders between technologies - strengthens this trend. An important element in any bundle is the broadband services, delivered over the fixed network. The ever increasing importance of these services assures the entry of new competitors into the fixed sector, and ensures that this process will not be a passing event.

The development of a wholesale market in the various subsectors should be worked out in cooperation between new operators and incumbent network operators. This cooperation should be reflected in terms of use, prices, etc. Unfortunately, past experience in Israel and abroad indicates, that the level of cooperation new operators can expect from an incumbent who is himself a service provider is minimal. Regulatory intervention is necessary, therefore, to ensure that the new operators and the incumbents compete on a level playing field. The concept of “non-discrimination” is a basic one in the regulation of the telecommunications sector, though a difficult one to enforce, mainly in situations where discrimination takes the form of service quality and availability, and in cases where cross-subsidization between a parent company which owns infrastructure, and a subsidiary which provides services, is possible. Unbundling causes daily friction between network operators and new entrants, and only clear and enforceable rules of conduct will allow this process.

As companies operators in different subsectors broaden their activities in the fixed sector, the incumbent’s subsidiaries, who are currently barred from cooperating with the parent company, will have difficulty dealing with the new challenges. Therefore, in order to ensure a level playing field, when unbundling is implemented, Bezeq’s subsidiaries should be allowed to provide bundles including fixed services offered by the parent company. One of the main services that upgrading of the access infrastructure will allow, is the provision of television services using IP protocol (IPTV).When unbundling is implemented, one of Bezeq’s subsidiaries will be allowed to provide this service, contingent on limitations on broadcast ownership.

The discrimination encountered by new operators from incumbent network operators is rooted in the double role these operators play, as infrastructure owners and service providers. The British regulator (Ofcom), which delved deeply into this issue, thought that the only solution to this conflict is the separation of ownership between the two operations, but settled for functional separation implemented by agreement. According to the model, the operation of infrastructure and service of the incumbent BT are handled by two separate divisions, operating for all intents and purposes as two separate companies. The Israeli regulator has separated fixed services (and network) from other services already fourteen years ago, thus limiting “Bezeq Fixed” to fixed line domestic telephony (including broadband) only. This separation has allowed the opening of the mobile, international, and the business exchange equipment markets to competition, protecting new entrants in these sectors from the threat of the fixed telephony and infrastructure monopoly. The committee believes that it would have been good if fixed services would have been separated from infrastructure. It does not, however, see any compelling reason to enforce structural separation, as long as “Bezeq” does not impede the creation of a wholesale market and of unbundling. The conflict of interest facing “Bezeq Fixed” will decrease as more and more services will be offered through subsidiaries.

The implementation of a level playing field in the provision of content for multi-channel broadcasting requires that similar separation rules are applied to the second fixed network provider – “Hot Telecom”. Bundles have become the most widespread instrument for new entrants to gain market share in a new market. The discounts that bundles offer, the use of brand equity from other subsectors, and the use of fewer suppliers, have caused this to be a more effective instrument than the provision of single, discounted services. However, bundles contain a grain of anti-competitiveness, in that they limit mobility. The anti-competitive potential is especially noticeable when the bundle consists of "tied" services. A clear example of the loss of consumer welfare and the anti-competitive potential of bundles can be found in the “basic channel package” in multi-channel broadcasting.

The “basic channel package”, consisting of forty channels, has accompanied the Israel consumer since the inception of the muti-channel cable operators, and has turned Israel into one of the most expensive countries in the world in which to purchase this service. Most Israeli consumers cannot receive terrestrial broadcasts, and have, therefore, to rely on the services of multi-channel television providers. Service of these providers is conditional on the purchase of the "extended basic package" of channels. The entrance of satellite service into the multi-channel broadcasting market has not affected this business model, and as a result there has been no decrease in the price and this competitive failure has not been removed. The "extended basic package" involves cross-subsidization between channels in the “extended package”, subsidies between the basic digital package and the analog package, and more seriously, subsidy of the value-added channels by the basic package. As a result, a content provider wishing to provide independent content directly to the viewing audience must compete with a subsidized price offered by the multi-channel broadcaster. This difficulty, in addition to the restrictions placed by the Commission for Cable Broadcasting and Satellite Broadcasting on the content of these additional broadcasts, creates an insurmountable barrier to the creation of a wholesale market in the multi-channel broadcasting sector, and results in total dependence of channel producers on the multi-channel broadcasting companies.

Committee Recommendations

Fixed Communications:

Structural changes in the fixed sector

1. The committee recommends the establishment of a wholesale market for fixed communications, with a requirement for local loop unbundling (LLU) as its central point. In this framework, incumbent universal network operators are to be obliged to sell wholesale services (resale, bitstream access, etc.) and to lease access network elements to competitors.
2. Competitors operating under this framework will be allowed to offer all services supported by the fixed infrastructure, contingent on licensing terms.
3. We recommend that the obligation to provide access to infrastructure to independent service providers operating in all levels of the wholesale market, be applied equally to all universal fixed network operators, contingent on technological practicability.
4. The obligation to provide unbundled access elements will apply, at this time, only to "Bezeq", due to technological constraints.
5. We recommend that within 15 months of the acceptance of these recommendations by the Minister of Communications, the regulatory body will publish maximum tariffs for leasing of access elements and other services offered in the wholesale market (resale, bitstream access, etc.), as well as terms and conditions for the provision of said elements and services. These tariffs and conditions will be set pursuant to a consideration of views of stakeholders.
6. The committee recommends that should "Bezeq" act to make redundant local exchanges in which competitors have installed equipment, the regulatory body shall protect those competitors who have invested in their own infrastructure, and whose competitive capability may be harmed from these actions, in keeping with European regulatory best practices.

Level Playing Field

1. The committee recommends that "Bezeq" subsidiaries be allowed to provide service bundles with no obligation to provide the services separately, including telephony and broadband services offered by "Bezeq Fixed", once wholesale market arrangements, including local loop unbundling, have been implemented, and competition using these arrangements has begun. At this time it will be possible to grant Specialized Domestic Telephony licenses to the subsidiaries, for the provision of non-VOB fixed services. If within six months of the implementation of wholesale market arrangements at all levels, competitors who use such services shall not be found, "Bezeq" subsidiaries shall be allowed to offer service bundles, unless the regulatory body becomes convinced that "Bezeq" is impeding the operation of the wholesale market on all levels.
2. We recommend that in the context of service bundles containing telephony and broadband services of "Bezeq Fixed", the subsidiaries (including YES) shall be allowed to offer IPTV services, whether on the upgraded "Bezeq" network, or by leasing access network elements and upgrading them, insofar as regulations involving cross-ownership are not violated.

Tariff Flexibility for "Bezeq Fixed"

As long as the "Bezeq Group's" market share remains above 60%, price control over "Bezeq Fixed" tariffs shall continue, in the form of fixed tariffs.
In the matter of "alternative tariff plans" offered by "Bezeq Fixed", the committee recommends:

1. The regulatory body will authorize an alternative tariff plan only if it is attractive to 30% or more of the subscribers who subscribe to the services offered in the plan.
2. The maximum allowable discount will be calculated as follows: The average discount rate given to those 30% of subscribers who would benefit most, out of

all subscribers who would benefit from the plan. The maximum allowable discount will be set in comparison the regulated tariffs at that time.

3. The maximum allowable discount will rise as “Bezeq Group” market share in fixed telephony decreases: 1. 15% while market share remains above 85% 2. 25% while market share is between 75% and 85% 3. 40% while market share is between 60% and 75% 4. When “Bezeq Group” market share falls below 60%, the restrictions on the maximum allowable discount on alternative tariff plans will be removed, and the regulated tariff will be defined as a maximum tariff.
4. These restrictions will not apply to existing alternative tariff plans.
5. In order to set the maximum allowable discount, market share will be measured according to the total number of subscribers who use the services included in the alternative tariff plan. In order to measure market share, we will draw a distinction between subscribers of standard telephone lines, and those who use multichannel telephony products (e.g. ISDN-PRI).
6. We recommend measuring the market share of competitors in the fixed telecommunications sector by measuring outputs weighed according to the “Bezeq” controlled tariffs, including subscription fees, in-network calls, out-of-network fixed calls net of interconnect, origination to mobile networks, and incoming interconnect.
7. “Bezeq Group” market share measurement, in order to set the maximum allowable discount on alternative tariff plans, will include the market share of “Bezeq Fixed” and subsidiaries, including VOB services.
8. In any case, the regulatory body will examine alternative tariff plans to ensure that these conform to non-discrimination provision, and that the tariff plan is not meant to target specific subscribers.
9. Each subscriber shall be allowed to subscribe to only one alternative tariff plan.

<u>“Bezeq Fixed” Regulated Tariffs</u>

1. Cost-oriented tariffs for fixed termination shall be set by mid-2009.

“Bezeq Fixed” Unregulated Tariffs

1. As long as “Bezeq” remains a declared monopoly, “loyalty discounts” shall be forbidden.
2. The regulatory body shall monitor the market share of competitors in multichannel telephony products for the next six months, and if no significant change in this market share becomes evident, the Minister of Communications shall use his authority under paragraph 15a of the Communications Law to set a cost-oriented tariff for ISDN-PRI service.

Structural Separation of “Bezeq”

1. The committee believes that as long as only two universal fixed network operators exist, structural separation of “Bezeq” should be maintained.
2. The committee recommends that should the Minister of Communications find, within a reasonable period of time after the implementation of unbundling (and no later than two years) that “Bezeq”’s actions are impeding competition in fixed communications, he shall use his authority under paragraph 4(d)(2)(3) of the Communications Law, to enforce structural separation between network operation and service provision in the “Bezeq” group.

Mobile Communications

1. The regulatory processes required to introduce virtual operators to the mobile sector, in accordance with Israeli Government decision 2816, should be speeded, as should the WIMAX tender, in order to encourage new entrants and to strengthen competition in the mobile sector. Additionally, action should be taken to increase competition by allowing the entry of new, infrastructure based operators.
2. The cost of mobile termination should be further examined, and the tariff should be adjusted accordingly in 2009.

3. Measures should be taken to reach agreement with European authorities on a reciprocal reduction in roaming charges, while simultaneously attempting to reach agreement with specific countries where Israelis travel frequently.

International Telephony

1. International telephony tariffs for calls originating on mobile networks shall be set by the international operators; they, in turn, will pay mobile network operators according to the rates set in the interconnection regulations for termination on mobile networks.
2. When the tariff structure of an international call from a mobile network will be changed in accordance with recommendation 1, the entry of new operators controlled by mobile network operators into the international telephony sector will be possible.

Multi-channel Broadcasting

1. The committee recommends a process by with a "narrow basic broadcast package" shall be offered, including 5-10 channels. These channels will include the free-on-air channels, as well as additional channels in which the regulatory authorities see specific social or cultural value. The price of this package will be set by the multi-channel broadcasters. Should the regulatory body find the tariff unreasonable, it will set the price itself. Subscribers to this package shall be allowed to purchase any of the additional channels, or bundles of additional channels, at a price set by the operators. In order to lessen the negative impact on subscribers to the analog basic package, and owing to the fact that analog subscribers cannot enjoy additional channels, we recommend that these subscribers receive a package identical to the "narrow basic broadcast package" and that the price be somewhat lower than the digital package, as it is today. Measures should be taken to cancel the analog package within three years.

2. In order to foster competition by special license holders operating on others' networks, in the spirit of the Communications Law, we recommend removing today's restrictions on the content of such license holders, and on the number of channels they may broadcast.
3. Subsequent to changes in the broadcasting landscape, a need will arise to re-examine the price a special license holder pays the general license holder to transmit his broadcast.
4. The committee recommends the creation of a Ministry of Communications team that will ensure the implementation of this new process within two to three years, while taking into account the financial stability of the companies operating in the sector. The team will examine, inter alia, the possibility of the creation of a wholesale market in the multi-channel broadcasting sector, in which special license holders will be able to provide the "basic broadcast package" along with additional channels. The wholesale price will be regulated.
5. The committee recommends that the Ministry of Communications enforce the structural separation between "HOT broadcasting" and HOT telecom set out in their licenses, in accordance with the separation framework existing in the "Bezeq" group.

Universal Service Obligations

1. There shall be no change in the current universal services basket.
2. The regulatory body will map the areas of demand for public telephone services and set service requirements accordingly.
3. High speed advanced services such as IPTV, delivered over technologies such as FTTx, VDSL2/2+, ADSL2/2+, etc., will be included in the universal services basket in 2013, unless it shall be proven at that time that the penetration of these services is low. The regulatory body shall set, at that time, the process for completing universal service.
4. If it shall be come apparent that the implementation of universal service in peripheral areas involves significant loss to the provider (or providers),

alternatives will be examined, including a tender process for the provision of services to the periphery, a fund that will be financed by companies in the sector, government assistance to cover losses, etc.

Consumer Issues

1. The committee views the OECD draft recommendations set out in this chapter as guidelines for dealing with consumer issues.
2. Service providers shall be barred from changing rates set in subscriber agreements during the term of the agreements.
3. Agreements in the household sector will not exceed 18-24 months.
4. A standard subscriber agreement will be published on the service provider's internet site.
5. Subscriber agreements between service providers and subscribers will include, at the beginning of the agreement and in exact form, in clear and understandable language, in short, and in clearly legible letters a paragraph of "main points". This paragraph will include the expiration date of the agreement, the cost of equipment, tariffs of the various services, the value of the discount contained in the agreement, the fine for breaking the agreement and the change in the fine over time, and all other financial aspects of the agreement. The "main points" will be a significant paragraph of the agreement, necessitating the subscriber's signature at the time of the signing of the agreement. Any change in the "main points" will require the subscriber's signature.
6. The regulatory body will act to remove the switching barrier caused by the linkage between equipment purchases and service purchases.
7. Subscribers shall be disconnected within two business days from the time the service provider received notice of a disconnection request. Subscribers will not be charged subscription or usage fees from that day onwards.

Regulation and Enforcement

1. The committee recommends that the Ministry of Communications be provide with adequate resources to operate a team dedicated to preparing the legal and tariff foundation necessary to establish a wholesale market in the fixe sector, and which will be given special authority which will allow effective regulation of the process. The level of resources will be set as to allow a team in a size commensurate with European experience.
2. The regulatory body will act to bring the financial penalties system into accordance with the need to deal with violations of regulations at the individual consumer level.

Royalties

The committee adopts the position of the Kroll Committee, which recommended a gradual reduction in royalty rates on communications license holders, up to a future removal of royalties, in accordance with fiscal requirements of the national budget. The committee recommends that should there be tax reductions in 2008-2012 (whether the decisions regarding these reductions were taken before this period, or during the period) the royalties shall be cancelled, no later than 2012. In order that consumers see the results of this cancellation, the cancellation should be accompanied by a commensurate reduction of rates, both tariff-controlled and non-controlled rates.