EUROPEAN COMMISSION

Brussels, 14.XII.2004

C(2004)4340 fin

Subject: **State aid N 126/2004 – United Kingdom**
Broadband for SMEs in Lincolnshire - "Connecting Rural Businesses"

Sir,

I. Procedure

1. By letter registered 15 March 2004 the United Kingdom authorities (hereinafter: UK authorities) notified the Commission of a project to finance the provision of advanced broadband services to SMEs in Lincolnshire. By letter registered 5 August 2004, the UK authorities notified a modification of the project, namely concerning some changes in the procurement procedures described below. The Commission asked for additional information on 14 May 2004 and 14 September 2004. The UK authorities replied by letters registered on 17 June 2004 and 21 September 2004, respectively. Additional information was submitted on 28 October and 17 November 2004.

II. Context

2. Lincolnshire County Council ("LCC") has identified technology as a key driver for economic development and business growth[1]. In this regard, the authorities considered that public service intervention was needed to address the non-pervasive supply of broadband services in the county and to induce business demand which has not materialised to levels required to make the necessary impact.

3. *Demand for broadband service:* Lincolnshire is a relatively rural and sparsely populated county located in the East Midlands.[2] It has a number of SMEs but with substantial dispersion of their location on its territory. The number of geographical business clusters is low and many businesses are spread around in rural areas. In addition, the number of high growth businesses is lower than in other counties. Such business demographics make the area less attractive to suppliers of advanced broadband services. As a result, a high proportion of businesses with potential growth opportunities are located outside the present availability of broadband.

---

1 In accordance with Local Government Act 2000, Part II, Arrangements with respect to Executives.

2 Population density is 109 people per square kilometres, which makes it the sixth most sparsely populated county in England. This compares to 267 people per square kilometre in the East Midlands and a national average of 377 people per square kilometre. (2001 Census)

The Right Hon Jack STRAW MP
Secretary of State for Foreign and Commonwealth Affairs
Downing Street
London SW1A 2AL
United Kingdom

4. *Supply of broadband services:* The level of broadband coverage in Lincolnshire is poor when compared to other counties in the East Midlands. People living on 61.83% of the geographic area are currently unable to access any broadband service.[3] The rate of deployment in Lincolnshire of asymmetric digital subscriber line ("ADSL") by British Telecommunications ("BT"), as part of its enablement program for the East Midlands, has been significantly slower than in other counties in the region. As of March 2004, only approximately 32 (24 of which are in the designated project area) out of the about 124 exchanges in the county have been upgraded to enable ADSL.[4] It should be noted, that even in areas where the exchanges are ADSL enabled, not all businesses located within an exchange area will have access, due to technical restrictions, mainly due to distance from the exchange.

5. *Basic services:* BT offers broadband services in Lincolnshire at downstream speed ranging from the basic residential offer of 512kbps to 2Mbps.[5] However, these services are asymmetric with much lower upstream speed. Such asymmetric services may well fit residential customers who typically download more data than they send out, but do not necessarily fit SMEs needing to communicate with suppliers, peers and customers. In addition, NTL also provides relatively low bandwidth, asymmetric, residential cable modem broadband services, although covers only a small part of the project area.[6] It should be noted that satellite services are probably also available throughout the area.

6. *Advanced services:* The target areas do not have "affordable" advanced broadband service coverage at the moment and are not included in the existing and ongoing coverage plans of service providers present in the county. A review of BT indicates that no deployment of symmetric digital subscriber line ("SDSL") broadband services has yet taken place in the East Midlands or in Lincolnshire, nor are there any indications of planned deployment in the upcoming two years. Data on exchange capacity indicates that the DSLAM capacity is average to below average, with no SDSL capability.[7] There are 2Mbps symmetric leased line service offerings – from BT on a wholesale and retail basis, and from NTL on a retail basis – but such dedicated services are beyond the affordability for most SMEs.[8]

7. The current limited availability of broadband services, especially affordable symmetric services aimed as SMEs, coupled with the unfavourable demographics for broadband take-up – low population density and low level of business clustering – seem to necessitate public intervention.

III Description of the measure

8. *Objective:* LCC has developed an "Information Technology Strategy" with two key programs: (i) Information and Communication Action Plan and (ii) Infrastructure. The subject of the notification is a project under the "Infrastructure" program, which aims to

---

3 This can be compared to 36.38% for the rest of the East Midlands (excluding Lincolnshire) (as of 03/2004).

4 This can be compared to 63% for the East Midlands (including Lincolnshire) (as of 03/2004).

5 BT offers asymmetric broadband services at 512kbps/256kbps, 1Mbps/256kbps and 2Mbps/256kbs speeds.

6 NTL offers asymmetric cable modem services at 512kbps/128 kbps and 1Mbps/236kbps speed.

7 DSLAM is the abbreviation for Digital Subscriber Line Access Multiplexer, a mechanism at a phone company's exchange that links many customer DSL connections to a single high-speed ATM line.

8 A typical charge for the provision of 2Mbps leased line service is around GBP 12,000 per annum.

address the supply side of broadband provision.[9] This so-called "Connecting Rural Businesses" project will provide a subsidy to a service provider ("SP") selected by a competitive tender to provide affordable advanced broadband services to SMEs in Lincolnshire.

9. *Beneficiaries*: The project aims to provide advanced broadband services to the 14,210 SMEs on the designated area of 4,991 square kilometres, with a minimum sign-up target of 3,000 SMEs.[10] Any single company or consortium, including telecom operators, service providers and system integrators, can participate in the tender to become the selected SP and receive the subsidy.

10. *Service definition:* For the purposes of the project, advanced broadband services are defined as at minimum 2Mbps speed symmetric services. According to the authorities, in addition to the differences in availability of broadband services between urban and rural areas in the UK, a significant divide relates to the speed and quality of the available services. In fact the authorities have commissioned two independent studies highlighting the need for higher speed and symmetric business broadband services for SMEs.[11] These expert reports claim that even where broadband services are available, the current service offerings have failed to address the specific needs of SMEs, which fall between basic residential type of broadband services and the dedicated capacity leased line services.

11. *Technology:* The project does not "a priori" prescribe any technology; it is up to the SP to propose the most suitable solution (e.g. DSL, satellite, etc.). LCC does not seek to procure or take ownership of any infrastructure. The project aims at service provision and it is up to the SP to build, buy or lease the infrastructure necessary to provide the required service. Hence the nature of the infrastructure will depend on the technical solution chosen but is likely to require investment in all layers of the network (i.e. both the trunk and the access layer) and may include ducts, new fibre, exchange-based equipment, masts and customer premise equipment.

12. *Retail service:* The SP is required to roll-out a retail service in a minimum coverage area and actually connect end-users, namely SMEs, who demand the service. While the project aims at providing affordable advanced broadband services, retail prices for the end-user service are not fixed or capped in advance. However, lower tariffs entail scoring benefits in the tender.[12] Moreover, since a minimum take-up of the service is a requirement, there are strong incentives to ensure competitive tariffs.

---

9 The "Information and Communications Action Plan" programme comprises a series of initiatives to stimulate demand for broadband services of businesses with a focus on applications. According to the UK authorities, projects under this program are covered by the rules laid down in the *de minimis* Regulation 69/2001/EC.

10 In accordance with Commission Recommendation 96/280/EC of 3.04.96, published in OJ L 107, 30.4.96, SME is defined as having <250 employees, annual turnover <=EUR40m or annual balance sheet of <=EUR27m and not more than 25% owned by an enterprise that is not itself SME. This definition is currently under review. If needed, the beneficiaries of the project will be adjusted to reflect the revised definition adopted by the Commission.

11 Report by Analysys illustrating the need for high speed and symmetric broadband services for SMEs and Report by Bell Hanson and Point Topic explaining why business-class broadband services will be essential for business growth and economic development.

12 The proposed tariffs are to be kept for the duration of the project and can only be altered with the prior agreement of the authorities.

13. *Wholesale services:* In addition to the retail services, the selected SP has a mandatory requirement to provide access to its network to third party service providers, referred to as re-sellers. However, the exact technical and commercial details of the open access provisions are not pre-determined, but are left to the candidates to describe in their proposals. The authorities have claimed that it is their intention that the SP should, wherever technically possible, also offer "raw" connectivity service to other communications providers in addition to pure resale. They have decided to avoid being over-prescriptive so as not to prejudice the technology neutral approach. Wholesale prices are also part of the tender scoring criteria and as such are expected to be competitive. Finally, the open access requirement will remain in force for the duration of the contract, i.e. until such time, as the total State funding have been repaid by the SP under the reverse payment mechanism (see paragraph 18).

14. *Procurement:* The selection of the SP will be conducted in accordance with EU procurement rules relating to the coordination of procedures of the award of public service contracts.[13] The contract will be awarded to the Economically Most Advantageous respondent to a tender. Only proposals which fulfil all mandatory requirements (e.g. open access) and pass the minimum threshold for service availability (e.g. coverage requirements) are evaluated as to the quality of the proposal. Quality is assessed based on scoring criteria ranging from roll-out speed to wholesale and retail prices.[14] Once the quality of the proposals is assessed, the one which represents the best value will be chosen. […][*]

15. *Contract:* Under the "Service Availability Contract" to be concluded between LCC and SP, payment for services provided to the SP will be linked to compliance with set milestones linked to the level of availability of broadband services to SMEs within the designated project areas. Eligible expenditure includes both capital expenditure and operating costs.

16. *Duration:* The SP is to offer a specified level of service availability by 31 December 2006. It is expected that the services will be self sustaining at that point and continue to be offered with no State intervention after that date, i.e. no further claims for public payments. Obligations under the contract relating to the services, including the open access requirement; and the reverse payment mechanism will however continue until such time as the public subsidy on the project has been repaid in full.[15]

17. *Budget*: The total project costs will be met by resources contributed by Lincolnshire City Council,the European Regional Development Fund ("ERDF") and the Service Provider. According to the authorities, the maximum public funding available for this project is GBP 4.25 million including UK state resources, as well as ERDF funding. Additional

---

[13] Directive 92/50/EEC of 18.06.92 as amended by Directive 97/52/EC and implemented in the UK by S/1993/3228.

[14] Scoring factors include sustainability, service support, completeness and comprehensiveness of the proposal, roll out speed, technical merit, candidate qualifications, coverage, end-user and reseller tariffs, service speed, service level commitments and guarantees, contention and service packaging including for services such as e-mail, web hosting, etc.

[*] Confidential information.

[15] A working example of the reverse payment mechanism based on the minimum requirements related to the take up of services estimates that without reinvested capital expenditure (capex), repayment would commence in Year 5 with full repayment in Year 11. However, with 5% of revenues being continuously reinvested as capex, repayment is expected to only commence in Year 8.

financing will provided by the selected Service Provider and it is expected that about 65% of the total costs of the project (including capital expenditure and first five years operating costs) will be financed through private resources, with the level of private sector contribution increasing over time as a result of the reverse payment mechanism. The corresponding aid intensity is hence expected to be around 35% of total project costs and could further decrease as a result of the reverse payment mechanism.

18. *Reverse payment mechanism*: The contract to be concluded between the LLC and the SP will provide for a level of public expenditure dependent upon the level of demand for the services. Through a reverse payment mechanism it will be ensured that as demand for broadband services grows, the contribution of the public sector diminishes. This reverse payment mechanism will operate on the basis of a percentage of net revenue from the provision of services being paid back to the authorities until such time, as the total fees paid by the State under the contract have been repaid.[16] However, the details of repayment cannot be determined ex-ante since they depend on the evolution of demand, as well as future business decisions of the service provider, i.e. the amount of revenues reinvested in the network as capital expenditure.

19. *Accounting:* The selected bidder is required to maintain open book accounting in order to enable the project sponsors to establish the levels of payments due to the SP, together with the sums due back. The "Service Availability Contract" will ensure that payments are only made in respect to costs incurred within the designated area (even if the SP's overall network may extend beyond it) and in relation to facilitating the required service (even if the SP has other activities). In addition, under the reverse payment mechanism the SP is required to provide full details of its revenues generated within the project areas, together with any capital expenditure attributable solely to the provision of the required services. The UK authorities consider that while there is no specific requirement of accounting separation between the subsidized and the purely commercial activities of the SP, the selected bidder will by necessity have to maintain such separate accounts given the above detailed requirements.

IV. Assessment of the measure: presence of aid

20. According to the EC Treaty and consolidated case-law there is State aid within the meaning of Article 87(1) when:

– there is an intervention by the State or through State resources;

– it confers an advantage on the recipient and;

– it distorts or threatens to distort competition;

– the intervention is liable to affect trade between Member States.

[16] The reverse payment is calculated as a percentage of revenue, after the deduction of capital expenditure (CAPEX) directly related to the provision of the minimum level of services required, net of any payments for service availability made by LCC. Revenues must be related to the project, excluding the first year from the service availability. CAPEX must be eligible capital expenditure directly related to the provision of service availability in the project area. The actual percentage of revenues equalling the reverse payment is set at 10%, which is said to be half of that which can be reasonably expected as an operating profit margin (20%). The formula used is as follows: Reverse payment= (RevenuesX10%)-(CAPEX-Payment for service availability by state).

State resources

21. Lincolnshire County Council is a UK local government and hence its resources, which are used to fund the "Connecting Rural Businesses" project, are to be considered as State resources.

Economic advantage

22. *Service provider*: An open tender procedure tends to minimise potential advantages to the service provider in terms of excessive returns. However, it should be noted, that the procurement procedure followed included a negotiation phase and has involved qualitative elements. Moreover, even if the SP would not receive an excessive return on its overall investment, it receives financial support providing the possibility of entering the market and establishing its business. The subsidy will by no doubt allow the SP to offer lower prices than it would have been able to offer had it had to bear all the costs by itself and, as a consequence, the SP will be able to attract more customers than under normal conditions. The fact that the subsidized market entry will coincide with a series of State supported initiatives to stimulate demand for business broadband services under the above mentioned "Information and Communication Action Plan" programme, will further help customer acquisition and contribute to a "first mover" advantage for the SP in the areas which currently have no advanced broadband services.

23. The authorities have claimed that the reverse payment mechanism is designed to avoid over-compensation by ensuring that revenues in excess of a reasonable profit – determined on the basis of analysis of a typical well run undertaking – are used to recover the project costs. However, even if eventually all public funds are repaid, payment of interest is not foreseen and their availability upfront is comparable to an interest-free loan. The absence of interest might imply a substantial reduction in the net present value of the repayment, particularly in view of the fact that no deadline is imposed on reimbursement and this could take place over a significant amount of time.[17]

24. As a result of the State contribution, the selected bidder is likely to acquire ownership of part of the infrastructure necessary to provide the services.[18] The SP will be in a position to exploit this infrastructure, as well as other tangible and intangible assets acquired with State funds (e.g. equipment, customer relations) even after the lifetime of the project and hence enjoy continuing benefits.

25. *End-users*: The objective of the State subsidy is to provide broadband services to SMEs which are currently not available in the designated project area, i.e. 2Mbps symmetric broadband services. In addition, according to the UK authorities, the aid will allow such services to be offered at "affordable prices". The currently available similar speed leased line offers are deemed too expensive for SMEs. The costs of rolling-out high-speed broadband services in a scarcely populated area like Lincolnshire are very high (see paragraphs 38-40.) and, without state-intervention, are expected to result in prohibitively high end-user prices. This is the reason why the authorities have asked for "affordable

[17] The UK authorities consider that an annual interest rate of approximately 9% is likely to apply to a project of similar risk and for similar loan amount of GBP 4 million. This is a purely indicative estimate based on an annual interest rate of 4% over British Bankers Association London Interbank Offered Rate (LIBOR). LIBOR was around 5% in June 2004.

[18] The selected bidder has the option of using infrastructure of third parties. In any case the infrastructure will be in the ownership of the private sector.

price" offers from potential service providers and have rewarded lower price proposals during the evaluation process. Hence businesses in Lincolnshire will benefit from service coverage beyond and prices below what would be provided purely on a commercial basis. In addition, they will enjoy an advantage in comparison to business located in other underserved regions of the UK. Considering that at least 3,000 SMEs are to be connected to the service, it seems that the advantage for each individual end-user beneficiary could be below the "de minimis" thresholds. However, the UK authorities did not provide any assurance relating to the respect of article 3(1) of the "de minimis" Regulation regarding cumulation and monitoring. Therefore it cannot be excluded that aid granted to end-users could exceed the limits set out in the aforementioned "de minimis" Regulation.[19]

26. *Resellers*: In addition, third party providers of broadband services are also expected to benefit from the State resources given the open access requirements. They, just like the SMEs, will be the customers of the SP, in this case, of wholesale products. In large areas covered by the project there is currently no broadband infrastructure and hence no wholesale offer at all, precluding market entry of third parties such as resellers without any infrastructure. In other areas, while the incumbent operator, British Telecom ("BT"), has enabled the exchanges to provide ADSL and, in accordance with the new EU Regulatory Framework[20], does offer certain wholesale products, it does not currently provide an advanced, high-speed, symmetric broadband wholesale product comparable to the one to be offered by the SP. Finally, while the prices of these wholesale products are not predetermined, given the fact that a subsidy is given, the project is aiming at a minimum coverage to be achieved via retail or wholesale services, and affordability is one of the scoring requirements, one would expect the wholesale prices to be lower than those that would be offered under normal market conditions without State intervention.

Distortion of competition

27. The intervention of the State alters the existing market by allowing new entrants into the provision of broadband services including the selected SP and, potentially, some third party providers. The fact that the services are procured via a tender does not completely remove this selective advantage given to the selected service provider. The new services will not only be offered in areas where broadband supply is totally absent, but also in zones in which broadband services, although possibly with different specifications, are already available through BT or NTL.[21] In making their decision to invest in broadband infrastructure and service, the incumbent telecom operators, BT and NTL, have based their calculation on the assumption that other operators would have had to bear the costs of a new infrastructure or pay a market price for its services, which is no longer the case after State intervention. Even if one of the existing operators were to be selected Service Provider, their original business models would have to be altered by coverage and open access requirements beyond their current regulatory obligations, if any. Furthermore, the subsidised service is more sophisticated and provides higher speed than the existing broadband services offered by BT and NTL, and the possibility can not be excluded that it will make some customers currently subscribing to these lower bandwidth services turn to the new, higher speed services. The effect on existing services may be even more imminent in the case of the dedicated leased line offers of the incumbents. Today, a

19 The *de minimis* Regulation 69/2001/EC

20 Regulation No. 2000/0185 on Unbundled Access to the Local Loop.

21 Cf. section II above.

number of SMEs may only be subscribing to those services due to the lack of a better priced alternative, as they may not actually need all the dedicated capacity and services[22]. Therefore, the fact that a new broadband service becomes available and at below market prices, has the effect of distorting competition.

28. In addition, while the LCC has decided to intervene precisely in view of the lack of purely private initiatives in most part of the region, it cannot be excluded that market initiatives could become viable in the medium term. By securing this project, the chosen SP will be capable of establishing its business and developing its customer base, enjoying a first mover advantage over prospective competitors. The state aid may also reduce the incentive for future market entry, especially in "marginal areas", i.e. where the rate of return of providing the broadband service is about or just below what would be acceptable for a private operator to enter without the aid

Effect on trade

29. Insofar as the intervention is liable to affect telecom operators and service providers from other Member States, the measures have an effect on trade. The telecom market is more and more open to competition between operators and service providers, which generally engage in activities that are subject to trade between Member States. There may also be an effect on competition between the end-users and their competitors in other Member States, although the importance of that effect will probably be relatively low.

Conclusion

30. In view of the above, the Commission considers that the project grants an economic advantage to the selected SP, as well as to the SMEs located in the designated project area and third party service providers. The project is publicly funded, distorts competition and has an effect on trade between Member States. Therefore the Commission regards the notified measure as constituting State aid within the meaning of Article 87(1).

[22] Leased line services guarantee a dedicated capacity of 2Mbps, while as per the Service Level Agreement the symmetric broadband services under the project will be shared in accordance to a maximum contention ration of 20:1.

V. Assessment of the measure: compatibility

31. Having established that the project involves aid within the meaning of Article 87(1) of the EC Treaty to the selected service provider, to the SMEs and to the re-sellers, it is necessary to consider whether the measure can be found to be compatible with the common market.

32. It should be noted that the areas covered by the project are located within Objective 2 assisted areas[23] or transitional areas[24] under the ERDF rules, however they are not all in assisted areas within the meaning of the Regional Aid Guidelines.[25] Hence the measure can not be assessed under the Regional Aid Guidelines.

33. The Commission notes that the project intends to ensure the widespread availability and use of advanced broadband services at conditions closer to those in areas with a greater density of population and businesses. The Commission acknowledges furthermore that the existing frameworks and guidelines cannot be applied to assess aid measures that specifically target this objective. The Commission therefore considers that the assessment of the compatibility of the measure with the common market needs to be based directly on Article 87(3)(c) of the EC Treaty.

34. Article 87(3)(c) of the EC Treaty states that:

> "aid to facilitate the development of certain economic activities or of certain economic areas, where such aid does not adversely affect trading conditions to an extent contrary to the common interest" may be considered to be compatible with the common market.

Necessity of the measure

35. Broadband access is seen as a necessary step for the modernisation of the EU society and economy and is a crucial aspect of the Lisbon agenda. It is a pre-requisite for the development of e-Government, e-Learning and e-Health projects.[26] Implementing the eEurope Action Plan 2005, EU15 Member States have put comprehensive national broadband strategies in place. This process is now being extended to all 25 EU Members.

36. Broadband is a type of service that by its nature is capable of positively affecting the productivity and growth of a large number of sectors and activities. Regional economic development benefits resulting from greater broadband deployment can include job creation and retention, more industrial growth, improved education and health systems and even reduced traffic congestion.[27] Moreover, its economic impact is closely linked to the extent to which it is diffused across a country or a region. This is partly because in network industries, the more people and firms use the network, the more benefits it

---

23 Under ERDF, Objective 2 are those economic and social conversion areas which face structural difficulties.

24 Objective 2 Transitional areas are those that did qualify for funding under Objective 2 in the programming period of 1994-99, but did not for the current status. They are eligible for special transitional funds between 2000-05 to help them complete restructuring.

25 OJ 1998 C 74, p.9.

26 Commission Communication COM(2004) 369 of 12.05.2004, "Connecting Europe at High Speed – National Broadband Strategies"

27 US Department of Commerce, Office of Technology Policy "Understanding Broadband Demand", September 2002

generates.[28] Finally the social and economic case for broadband takes on added significance for rural and remote communities, where improved communications can address a variety of challenges posed by distance.[29]

37. Despite being the fourth largest county in England, Lincolnshire is peripheral to key communication routes, e.g. there is no motorway network at all. There is also a significant and widening gap in terms of Gross Value Added between Lincolnshire and the rest of the UK. The limited physical infrastructure and economic weakness of the area increase the importance of facilitating communications technology take up. It is believed that through provision of advanced broadband services, employment, sales and innovation in SMEs could increase.

38. However, the cost characteristics of broadband networks are such that services are generally much more cost effective to roll out, and hence available on cheaper terms, where demand is higher and concentrated, i.e. in densely populated and in relatively wealthy areas. High "economies of density" have usually been a key success factor in countries and regions where there has been rapid deployment of broadband.[30] On the downside, such economics may have the effect of increasing the disadvantages for less developed or scarcely populated areas such as Lincolnshire. As seen from various broadband demand registration schemes in the UK, operators are often unwilling to make the necessary investment in upgrading the infrastructure unless a certain level of demand concentration is guaranteed beforehand.[31] However, such schemes did not deliver the desired coverage in Lincolnshire, where less than 30% of the exchanges have so far been ADSL enabled.

39. The reason for such "economies of density" is that most broadband technologies today are inherently uneconomical in low population density areas since unit costs escalate dramatically as population densities drop. High average costs per users for broadband services are mainly driven by high capital costs, especially in the access network. In the case of fixed networks, 65-70% of the costs associated with the deployment of broadband in the access network are related to civil infrastructure.[32] These costs are particularly high in rural areas.[33] In addition, although equipment costs have fallen as volumes increase, they remain a significant cost and a major barrier to roll-out.

---

28 OECD "The Economic Impact of Information and Communication Technologies (ICT)", 2004

29 OECD "Broadband Driving Growth: Policy Responses", October 2003

30 For instance, Korea has experienced rapid roll-out partly due to its demographics (e.g. 480 people/square kilometre versus 245 in the UK), large number of people living in high rise buildings., Brunel University and UK Department of Trade and Industry "Investigating Broadband Technology Deployment in South Korea", July 2002

31 Until recently, BT ran a broadband registration scheme. It published a list of exchanges and a minimum trigger level for each, i.e. the number of subscribers which had to register their demand in advance in order for BT to schedule an upgrade of an exchange to carry DSL. Easynet, an alternative provider using unbundled local loop, started a similar scheme in 2003. This scheme also took into account the expected amount of use with potentially high volume users scoring more towards initiating the investment.

32 UK Broadband Stakeholders Group "Broadband in Rural Areas", 2003

33 U.S. National Exchange Carrier Association "Rural Cost Study" 2000 for example, concluded that the cost of upgrading 1.7 million mostly rural lines in the US would be EUR 3,500 each. Reaching the 600,000 most remote households would cost EUR 8,000 per a line.

40. Public sector intervention may thus be needed to support broadband rollout in rural areas by stimulating demand, as well providing seed money to jumpstart private investment in areas which are otherwise underserved. With the increasing level of public support for broadband initiatives, there is growing evidence that public intervention may accelerate the establishment of a broadband network in the less profitable areas, while ensuring, by means of open access requirements, that competition is preserved in the future.[34]

Proportionality

41. In order for the aid measure to be compatible with Article 87(3)(c) of the EC Treaty, it must be moreover proportionate to the objective and must not distort competition to an extent contrary to the common interest. The trade-off between the advantages – in terms of a local economic development, support to information society and enhancement of competition between telecom operators and service providers – and the disadvantages – in terms of distortion of competition and possible disincentives to private investment – has to be assessed. The extent of the measure in terms of service definition, as well as project design features should also be evaluated to ensure that the least distorting model, which would nevertheless produce the required results, is adopted.

42. In this respect the Commission notes the following positive elements:

(1) *Combination with demand side measures:* The project involves subsidizing the broadband service provision in combination with demand side measures such as demand aggregation. Demand side measures, e.g. policies to aggregate public demand, are generally seen by industry as less distortive from a competition point of view than supply side measures.[35] As such, it is preferable that supply side measures are accompanied by demand side interventions to minimise the supply side subsidies needed to ensure service take-up and sustainability.

(2) *Tender:* The selected service provider benefiting from the subsidy has been solicited from the open market in accordance with EC rules and principles on public procurement. The tender, seeking the Economically Most Advantageous proposal, is designed so as to minimise the cost of investment and the associated public funding, while still ensuring an appropriate level of service.

(3) *Technology neutrality*: The project is technology neutral, i.e. it does not favour a priori any given technology.

(4) *Open-access:* The selected service provider will lease capacity to resale operators and service providers on a transparent and non-discriminatory basis guaranteeing an open access. The pricing of these wholesale services are expected to be favourable since they are one of the scoring criteria in the tender.

(5) *Existing infrastructure:* The service provider is free to choose the most efficient way of procuring the necessary infrastructure, either by building, buying or leasing it from third parties. By avoiding specific requirements to build new infrastructure, the projects minimises duplication. Since leasing facilities is expected to be more cost effective than building new infrastructure, existing operators will have the possibility to contribute their infrastructure to the project,

---

34 For instance the Stokab project in Sweden.

35 Op. Cit. 33

which limits the economic impact of the project for operators that already have infrastructure in place.

(6) *Aid amount and intensity:* First of all, the selected provider is expected to contribute an initial 65% of the total project costs. Secondly, the reverse payment mechanism, under which a progressive reimbursement of the public funding is expected to take place as demand for services picks up, ensures that only the minimum necessary public funds are used.[36] Finally, given the size of the project and the number of enterprises concerned, the aid amount potentially reaching reseller service providers and end-users is certainly limited.

(7) *Duration:* It is expected that the services will be self sustaining by December 2006, after which point no further claims for public payments can be made. The public funding is thus limited to the initial stages of the project and aims to jumpstart the service.

43. At the same time, the Commission notes the following aspects which could raise concern:

44. *Price distortion*: The Commission notes that the project intends to ensure the widespread availability and use of advanced broadband services at conditions closer to those in areas with a great density of population and business. In this respect, the Commission took notice of the fact that the tender to select the Service Provider has left open the level of retail and wholesale tariffs charged for the subsidized services. Candidates were invited to put forward price proposals as part of their bid, with lower prices scoring higher in the selection process. As noted in the Commission's decision "*Cumbria Broadband – Project Access*", appropriate pricing of the services is especially important to ensure that commercial end-users benefiting from the aid are not put in a position more favourable than their competitors located in regions where the same advanced broadband services are already available on pure market terms.[37] Indeed, disproportionately low prices may necessitate more aid than the minimum necessary to address the undersupply of the service in certain areas. Addressing this issue, the UK authorities gave assurances that the tariffs to be applied by the selected Service Provider will be consistent with those provided by the same provider in other areas of the UK, where they do not benefit from State resources. Based on a benchmarking exercise, the rates will also be comparable with tariffs offered by some of the other service providers in other areas. Therefore there will be no discrimination between customers being provided the relevant services within the designated project area and other customers.

45. *End-to-end service provision:* The project intends to procure an end-to-end service. This means that the selected bidder will not only have the task of arranging the necessary infrastructure for granting access to third party providers, and as such make broadband available to end-users, but will also have the obligation of providing itself the end service on customers' request. In general, the chosen approach differs from a pure infrastructure project in several respects:

---

36 While there is a legal obligation on the SP to reimburse the subsidy, since the scheduling of repayment depends on market evolution, it is not possible to specify the timing and quantify ex-ante the aid amount.

37 In "Project Access" the UK authorities provided a benchmark rate equal to the cheapest available rates for the specific broadband service being offered on a retail basis to a majority of users at a national level. Commission decision N282/08 of 10/12/03 published OJ C16 22/01/04

- on the one hand, an end-to-end service typically involves a lower detail of specification as to the type of infrastructure and technical means required by the authorities. This has the advantage of allowing better exploitation of existing installations and greater technological neutrality;

- an end-to-end service might also be preferable in cases where there is less need for building and managing new infrastructure and focus is on the rapid availability of the service to end users. By tendering the final service, the authorities have greater certainty on the scope and timing of the final service;

- a project that includes the provision of the final services allows greater commercial opportunities to the selected bidder and is likely to attract a greater amount of private funding. This might entail lesser use of public resources and lower aid intensities. In addition, it should be noted that the UK authorities argue that given the demographics, the mere establishment of an infrastructure would not be sufficient to ensure the commercial viability of the provision of the defined services in Lincolnshire[38], even though the authorities have not provided sufficient evidence in this regards.

- on the other hand, this type of project can be seen as more distortive than one merely consisting in the provision of infrastructure, since it will intervene in a greater number of markets, including those downstream markets in which public intervention appears less needed. This is in line with the views of the UK Broadband Stakeholder Group ("BSG"), which considers that in most cases public support for third party infrastructure (especially civil infrastructure), sold on a non-discriminatory wholesale basis to service providers, should be sufficient to reduce overall investment costs and lower barriers to service provision;

- it should also be noted that in certain 'infrastructure projects' the State retains ownership of the infrastructure and attributes its management – through a concession of limited duration – to an independent party that cannot act as service provider. This solution preserves the neutrality of the infrastructure manager, as opposed to a situation in which a service provider has control over the infrastructure.

- finally, end-to-end service requirement may put the ISP of the SP at an advantage, who is likely to be in a position to roll-out end-user service prior to the entry of third party providers benefiting from the open access and, as such, foreclose the market.

46. Summing up the various considerations and taking into account the characteristics of the project already mentioned – in particular open access, limited amount and low intensities of aid – the Commission considers that in this particular case, the distortive effects of an end-to-end service, as opposed to the mere establishment of an infrastructure, are not of such an extent as to be contrary to the common interest. Although the selected bidder will be advantaged with respect to other service providers, the amount of aid is limited and the obligation to provide wholesale service will allow entry in downstream markets. The stimulation of demand and the launch of new services might also have beneficial effects on competitors.

[38] For instance there may be an insufficient number of SME customers demanding service from a Digital Local Exchange (DLE) to justify the cost of fibre backhaul from the service provider's nearest point of presence.

Conclusion

47. In view of the above, the Commission considers that the public investment in "Broadband for SMES in Lincolnshire – Connecting Rural Businesses" will only be provided to the extent necessary to develop the use of broadband services of SMEs. This is in line with Community priorities as indicated in the e-Europe 2005 Action Plan. The intervention is designed in a way that does not distort competition to an extent contrary to the common interest.

48. Accordingly, the Commission has come to the conclusion that "Broadband for SMEs in Lincolnshire – Connecting Rural Businesses" is compatible with Article 87(3)(c) of the EC Treaty.

VI. Decision

49. On the basis of the foregoing assessments, the Commission has accordingly decided that the aid involved in "Broadband for SMEs in Lincolnshire – Connecting Rural Businesses" is compatible with Article 87(3)(c) the EC Treaty.

If this letter contains confidential information which should not be disclosed to third parties, please inform the Commission within fifteen working days of the date of receipt. If the Commission does not receive a reasoned request by that deadline, you will be deemed to agree to the disclosure to third parties and to the publication of the full text of the letter in the authentic language on the Internet site: http://europa.eu.int/comm/secretariat_general/sgb/state_aids/. Your request should be sent by registered letter or fax to:

European Commission
Directorate-General for Competition
Directorate State Aid II
Joseph –II, 70
B-1049 Brussels
Fax No: +32 2969816

Yours faithfully,

For the Commission

Neelie KROES
Member of the Commission