

by Cento Veljanovski

Competition law: the new regulatory tool?



The telecommunications sector today looks radically different from that 40 years ago when the IIC was formed. Then competition was a dirty word. The received wisdom was that competition was impractical, detrimental and technically impossible. The only feasible policy was to have one fully integrated fixed network owned by the government, often referred to as the Public Telecommunications Operator (PTO). As new technologies came on stream, they were treated as complementary to the fixed network to be run by the PTO.

This monopoly model is no longer accepted. Indeed it died several decades ago. Competition is now the mantra – it is good for consumers; good for industry; and forms the core of the new regulatory order.

Yet despite the unpredicted and phenomenal success of mobile telephony and the Internet some remain disappointed with the pace, breadth and depth of competition. This is not confined to the incumbent fixed operators who have retained considerable market share, but also the mobile and Internet sectors where bottlenecks have been identified.

The premise of the new order is that competition requires regulation to facilitate, and sometimes force, competition. If competition is the future so, it appears, is regulation. And we are

also seeing a return of what might be called 'industrial activism' to develop new generation networks (NGNs) that will bring high speed broadband and close the so-called 'digital divide'.

What is competition?

Why is there a continuing need for regulation in a sector so susceptible to competition and innovation? After all when the IIC was formed there were no mobiles, no Internet, and no WiFi – all services taken for granted today.

One reason is that the notion of competition has altered over the course of the last several decades.

In the early years of liberalisation competition was seen in relatively simple terms – remove the PTO's legal monopoly, liberalise equipment and Value Added Services to varying degrees, and encourage service providers to compete with the PTO at the retail level.

This service-based model of competition had limited potential because the incumbent PTO retained control of the network over which these services passed, and it also was a major service provider. This led to vigorous attempts to foster direct network or facilities-based competition by licensing new fixed operators, divesting the PTOs of their cable networks, allowing cable

operators to provide voice telephony since most were confined to the retransmission of television channels, and increasing the number of mobile networks.

Competition was measured by the number of rival networks and service providers on the assumption that more was better. Indeed, Oftel, the UK telecoms regulator, at one time assumed that the existence of three fixed operators signalled the dawn of effective competition.

Today the picture is more complex as regulators have sought to fill in the gap between fully-fledged network competition and service competition. This has taken the form of mandating direct access, wholesale leased lines, and unbundling the networks of those operators with Significant Market Power (SMP). Access regimes abound, such as the EC's New Regulatory Framework (NRF)¹ enacted in 2003 which governs EC communications law. These are seen as ways of taking 'control' of the network away from the incumbent operators to facilitate more competition given the high fixed costs of developing alternative fixed networks.

Fixed v mobile?

At one level this regulatory preoccupation with the fixed sector seems strange given the phenomenal growth of mobile telephony. Mobile penetration exceeds 100 per cent in most countries with mobile traffic surpassing fixed traffic, offering the same range of services, and with many households now abandoning fixed services. And most significantly mobiles have increased the level of direct network competition significantly since most countries have between two to five separate mobile networks offering national coverage.

However, the mobile sector has not been immune from regulatory intervention. Despite the growth of mobile networks and penetration, they have not exerted much pressure on the prices of fixed services. Indeed, mobile prices are many orders of magnitude higher than fixed tariffs. While this can be partially explained by the greater functionality of mobile services (their mobility), there was another reason.

¹ Directive 2002/19/EC on access to, and interconnection of, electronic communications networks and associated facilities, 7 March 2002; Directive 2002/21/EC on a common regulatory framework for electronic communications networks and services, 24 April 2002 and Directive 2002/22/EC on universal service and users' rights relating to electronic communications networks and services, 24 April 2002.

Mobile networks suffered from a bottleneck monopoly problem. This was due not to the industry's structure i.e. the number of different networks and/or their market shares, but to the way mobile services were priced. In most countries Calling Party Network Pays (CPNP) pricing is used for all calls (apart from international calls). Under CPNP the calling party's network operator pays for the call including the termination charge levied by the terminating network. This gives the terminating network market power because the customers of other (call originating) networks pay the terminating charges. As a result there are insufficient competitive constraints on termination charges.

Some issues

What has been the role of competition law in these developments?

Despite the pedigree of competition law, it is seen as inadequate to deal with the pockets of persistent market power that remain in the telecoms sector. Indeed, as the sole method of controlling market power it cannot be relied on, unless an access regime is grafted onto the basic structure of the law. The experience of New Zealand demonstrated this. In the early 1990s it bucked the trend by relying exclusively on competition law and litigation to control the incumbent fixed operator. The result was interesting case law², but little progress in fostering a more competitive telecoms sector. The legacy of this approach in New Zealand has been a swing (some would say overshoot) in the other direction by mandating functional separation of the incumbent fixed operator, Telecom NZ.

Nonetheless competition law has had a profound impact on the way the communications sector is regulated.

First, it has provided the basis for regulation of the communications sector. In the 1990s all the talk was about technological and economic convergence of mobile, broadband and fixed services. This underpinned in large part the push for a converged legal system, at least for Europe. Ex ante regulation (or what we simply knew as regulation) under the EC New Regulatory Framework 2003 was based on competition law

² *The Telecom Corporation of New Zealand v. Clear Communications Ltd* 6 TCLR 138 [1994]. Also Court of Appeal judgment, *Clear Communications Ltd v The Telecom Corporation of New Zealand* 5 TCLR 413 [1993], and High Court judgment, *Clear Communications Ltd v The Telecom Corporation of New Zealand* 5 TCLR 166 [1993].



principles. This legal convergence is based on the competition law principles of market definition,³ market power using the competition law concept of dominance and its regulatory counterpart Significant Market Power (SMP), and remedies from the competition law toolkit with the exception of price controls.

Second, the ex ante regulatory system and competition law are complementary. That is the former is seen as a stop-gap or transitional response to the perceived inadequacies of competition law in dealing with persistent pockets of market power. Ex ante regulation is (formally) triggered by the so-called '3-criteria test' - (1) high and non-transitory barriers to entry; 2) market not effectively competitive; 3) insufficiency of competition law.⁴

The inadequacies of competition law response are that it is slow, piecemeal, subject to manipulation by large incumbents, and has inadequate remedies. However one should not be fooled into thinking that this is an inherent feature of a competition law response. In some countries access regimes have been added to their competition laws and administered by a competition

³ Explanatory Note to the Commission Recommendation of Relevant Product and Service Markets within the electronic communications sector, Second Edition, C (2007)5406.

⁴ European Regulators Group, Report on Guidance on the Application of the Three Criteria Test, June 2008.

authority e.g. Australia and New Zealand.⁵ And paradoxically in some countries the only competition law until very recently was that applied to regulate the telecoms sector e.g. Hong Kong and Singapore.

Third, ex ante regulation and competition law operate concurrently. Recent cases have confirmed that an SMP operator's compliance with its regulatory obligations does not give it immunity from prosecution under competition rules.

This was amply clarified by the European Court of First Instance in *Deutsche Telekom*,⁶ and more recently by the English High Court of Appeal which set out what it termed a 'modified Greenfield approach' 'requiring regulation to be ignored which would otherwise distort inappropriately the answer to the enquiry whether a network operator has SMP.'⁷

While there is significant convergence between ex ante regulation and competition law, there are also significant differences and consequences:

First, competition law is more focused than ex ante regulation. It is about maintaining the conditions of competition rather than controlling

⁵ EC competition law was developing an essential facilities approach and 'access regime'. EC Commission, Notice on the application of competition rules to access agreements in the telecommunications sector – Framework, Relevant Markets and Principles, OJ C265, 22 August 1998.

⁶ Case T-271/03 *Deutsche Telekom AG v. Commission* (2008).

⁷ Etherton L.J. at para 92, *Hutchison 3G UK Ltd v OFCOM* [2009] EWCA Civ 683.

prices and access terms. This distinction has at times been blurred as, for example, in the European Commission's recent decisions on margin squeezes⁸ and dominance where it has come very close to acting as a price regulator. Indeed in the US the demarcation is more graphic since under US antitrust law there is no duty to deal, and therefore failure to give access is not, at least following *Trinko*⁹, an antitrust offence.

Second, competition law's narrow focus on competition means that it is reluctant to take into account efficiency and investment considerations. Yet these are among the most critical issues in the development of communications sector and its regulation. The focus of most competition laws is competition and specifically controlling the exclusionary abuses of SMP operators who seek to prevent or reduce competitive pressures.

The role played by efficiency and investment is not prominent in this area (which under European law is covered by Article 82 of the EC Treaty). Indeed there is a reluctance to pay too much attention to efficiency concerns in competition policy for fear that this will open the floodgates for industrial policy initiatives which cut across protection competition.

The third concern relates to structural remedies. While merger law (which is a component of competition law) deals with structural issues these tend to be prospective. The ability to apply competition rules to effect major structural changes in the industry have been used sparingly although the increasing use of sectoral investigations may change e.g. the UK competition regulator forced the incumbent gas supplier (British Gas) to separate transmission from distribution.

Fourth, a considerable amount of competition has been contrived by regulation rather than market forces. Regulators have sought to reduce the incumbent's market share, and when the preferred policy has not generated sufficient results they have initiated another round of policy and regulatory initiatives to further fragment the sector. This can be clearly seen in the evolution of broadband policy.

When regulators felt that service competition was not going to generate massive returns and direct network competition would be slow to develop because of the high infrastructure costs,

8 C. Veljanovski, *Margin Squeezes in Telecoms*, Intermedia, 2008, Vol. 36, pp. 10-13.

9 *Verizon Communications, Inc. v. Law Offices of Curtis V. Trinko, LLP* 540 U.S. 398 [2004].

access was mandated to various parts of the incumbent's network. The idea is that wholesale access, whether of leased lines, bitstream access or Unbundling Local Loop (ULL), allows entrants to mix-and-match self-provision with the incumbent's network assets thus encouraging more competition and accelerating broadband take-up.¹⁰

Finally, these interventions have costs and create distortions. Steps to accelerate competition using the incumbents' network invariably reduce the incentives of rivals to invest in their own networks. This will be especially so where access has been made too easy or cheap. These concerns have led to investment being explicitly taken into account in many access regimes.

An example of the former was the recent flirtation with the so-called 'ladder of investment'¹¹ concept where access was timetabled and limited to a schedule of investment by entrants.

But the evidence indicates that there are trade-offs between access regulation on the one hand, and network competition and investment on the other, that may well have reduced rather than enhanced the prospects an effectively competitive telecommunications sector. Most of the published studies show that effects of ULL are small¹², transient¹³ and statistically insignificant¹⁴, and that the normal diffusion of new technology

10 OECD, *Communications Outlook 2007*, Paris; OECD, *Developments in Local Loop Unbundling*, 2003, Paris; OECD, *Local Access Pricing and E-Commerce*, 2005, Paris.

11 European Regulators Group, *ERG Common Position on the Approach to Appropriate Remedies in the New Regulatory Framework*, ERG (03) 30rev1, April 2004. M. Cave, *Encouraging Infrastructure Competition via the Ladder of Investment*, *Telecommunications Policy*, Vol.30, 2006, pp.223-237.

12 S. Wallsten, *Broadband And Unbundling Regulations In OECD Countries*, Working Paper 06-16, 2006, AEI-Brookings Joint Center for Regulatory Studies.

13 M. Denni and H. Gruber, *The Diffusion of Broadband Telecommunications: The role of competition* paper to International Communications Society conference, Pontevedra, Spain, 2005.

14 W. Distaso, P. Lupi and F. Manenti, 'Platform Competition and Broadband Uptake: Theory and empirical evidence from the European Union', *Information Economics and Policy*, 2006, Vol. 18, pp. 87-106; J. Kim, J. Bauer and S. Wildman, *Broadband uptake in OECD Countries: Policy lessons from comparative statistical analysis*, paper to 31st Research Conference on Communication, Information and Internet Policy, September 19-21, 2003, Arlington, Virginia, USA; I. Cava-Ferreruela and A. Alabau-Munoz, *Broadband Policy Assessment: A cross national empirical analysis*, *Telecommunications Policy*, 2006, Vol. 30, pp. 445-463. J. Hausman and G. Sidak, *Did Mandatory Unbundling Achieve Its Purpose? Empirical evidence from five countries*, *Journal of Competition Law and Economics*, 2005, Vol. 1, pp. 173-245.

largely explains the growth of broadband within the OECD.¹⁵

Howell¹⁶ shows that direct network competition between DSL and cable is more effective in promoting coverage and take-up of broadband than ULL. Other studies show that wholesale access has reduced investment by entrants - one study estimates that it would have been about 8.5% higher without access regulation.¹⁷

What of the future?

What are the issues which will vex operators and regulators in the future?

Continued but more focused Regulation. The pressure to, in effect, 'dismantle' the fixed SMP operator's networks is set to continue. The reason is that they retain significant market share of fixed services. Based on retail revenues, incumbent operators had around 70% for local calls, over 60% of fixed to mobile calls, and around 57% for international calls on average across the EU in 2005.¹⁸

Their presence in wholesale/network markets is even more pronounced. The proposals to reform the NRF will reduce the number of ex ante markets from 18 to seven, remove retail

regulation, and focus on wholesale markets. But the sector will continue to be micromanaged as new problems arise and entrants lobby hard for greater controls on larger competitors such as functional separation (see below).¹⁹

Foreclosure and Functional Separation. The vertically integrated structure of fixed operators is seen by some as the reason for the slow progress of competition in the fixed sector. This has led a search for a structural solution including the radical and controversial policy of functional separation. Functional separation would create separate entities for the SMP operators' wholesale and retail (and other) activities which will remain under common ownership, but would be run by independent management, with separate profit and loss accounts, and deal at arms' length with one another and its rivals.

This, it is argued, reduces the likelihood that the market power that comes from the SMP operator's control of the local loop from being leveraged downstream to prevent and reduce competition. Functional separation has so-far occurred in the UK with Ofcom's 'deal' that BT separate its retail and wholesale business in return for lighter regulation,²⁰ Italy and Sweden, and New Zealand where Telecom has been separated into three semi-autonomous units (network, wholesale and retail) and moves are afoot in Australia²¹. Also the proposed reform package of the NRF by the EU adds functional separation as an ex ante remedy.²² Regulators in other countries (France, Spain and the Netherlands) have rejected the proposal as too interventionist. The costs and benefits of various types of separation have yet to be fully spelt out, and will certainly

15 The most recent study commissioned by the OECD claims that ULL has been the most significant factor in the absence of direct network competition. OECD, *Catching-Up in Broadband – What will it take?* Working Party on Communication Infrastructures and Services Policy paper DSTI/ICCP/CISP(2007)8/FINAL, Paris. However this result appears to have been due to statistical errors - G. Boyle, B. Howell and W. Zhang, *Catching Up in Broadband Regressions: Does Local Loop Unbundling Really Lead to material Increases in OECD Broadband Uptake*, New Zealand Institute for the Study of Competition and Regulation, July 2008.

16 B. Howell, *Broadband Uptake and Infrastructure Regulation: Evidence from the OECD Countries*, ISCR Working Paper BH02/01, February 2002. See DotEcon/Criterion Economics, *Competition in Broadband Provision and its Implications for Regulatory Policy*, October 2003.

17 H. W. Friedirizik, M. Grajek and L.H. Roeller, *Analysing the Relationship between Regulation and Investment in the Telecom Sector*, ESMT, November 2007. Also L. Waverman, M. Meschi, B. Reillier and K. Dasgupta, *Access Regulation and Infrastructure Investment in the Telecommunications Sector: An Empirical Investigation*, ETNO, September 2007; P.W.J. Bijl and M. Peitz, *Innovation, Convergence and the Role of Regulation in the Netherlands and Beyond*, TILEC Discussion Paper, May 2007. But see the more positive findings in the EC Commission sponsored study by London Economics/ PricewaterhouseCoopers, *An Assessment of the Regulatory Framework for Electronic Communications: Growth and investment in the EU e-communications sector*, final report to the European Commission DG Information Society and Media, July 2006

18 European Commission, *European Electronic Communications Regulation and Markets*, 12th Report, March 2007, Vol. 2, Fig. 7.

19 European Commission, Proposal for a Directive of an European Parliament and of the Council amending Directives 2002/21/EC on a common regulatory framework for electronic communications networks and services, 2002/19/EC on access to, and interconnection of, electronic communications networks and services, and 2002/20/EC on the authorization of electronic communications networks and services, November 2007.

20 Office of Communications, *Telecommunications Statement*, June 2005.

21 Telecommunications Legislation Amendment (Competition and Consumer Safeguards) Bill 2009.

22 European Commission, Proposal for a Directive of an European Parliament and of the Council amending Directives 2002/21/EC on a common regulatory framework for electronic communications networks and services, 2002/19/EC on access to, and interconnection of, electronic communications networks and services, and 2002/20/EC on the authorization of electronic communications networks and services, November 2007.

be the subject of continuing debate for the next decade.

Pricing Termination. Competition alone will not remove network operators' bottleneck monopoly of termination. This is not a structural problem but one due to CPNP pricing. The problem of termination charges has led to two decades of regulatory activity which has been notable for its laboured analysis of the problem, and the continuing need for price caps to bring down what have been deemed excessive prices. This debate will however move on to more radical remedies perhaps altering the method of pricing termination by replacing CPNP with MPNP or, even more controversially, bill-and-keep.²³

Non-competition Objectives. Governments are becoming increasingly interventionist in order to promote investment in high-speed broadband networks. These policies are not market-based as the investment needed to extend networks out to the last 10 or 20 per cent of the population is often wildly uneconomic. Moreover, the political push to close the digital divide is the old style universal service obligation in another guise. The idea here is that citizens have some natural right to broadband access and services, even if not at the speeds and quality in urban areas. Since it is uneconomic to provide national coverage the funding must come from the industry, government and/or consumer, or some combination of all three.

This has led to proposals for public subsidy, regulatory holidays to provide the revenues to fund uneconomic investment, and other schemes such as the Carter Review's proposal for a 'telephone tax' in the UK.²⁴ The question of why, how and who pays, and the implications for the regulation of the sector, have flared up and led to some very nasty confrontations e.g. between Telstra, the competition regulator (the ACCC) and the Australian government.

The Rise of the Consumer Interest. There is emerging an increased focus on consumer welfare. There are dangers that this transforms into a populist movement especially under political pressures. While the ultimate goal of competition and regulation should be to protect the long-term interests of the consumer, there

23 C. Veljanovski, *Bill and Keep: A solution to the termination monopoly problem?* Casenote, Case Associates, October 2007.

24 *Digital Britain: Final Report*, UK Department for Culture, Media and Sport and Department for Business Innovation and Skills, June 2009 ("Carter Review").

is a danger that the focus will be on their short-term interest in lower prices. This can damage the willingness of operators to invest in new technologies and hence harm future generations of consumers.

Futuristic Regulation. Another concern is the competence of competition and telecoms regulators to deal with dynamic sectors such as communications. Past experience has shown that they either fail to understand developments or seek to adopt fashionable theories of competition and regulation.

This is nowhere better illustrated than in several competition law decisions which have sought to regulate yet to be established, and as it turned out, failed 'future markets'.²⁵ For example, in European Commission's *Vodafone/Vivendi/Canal Plus*²⁶ decision it defined numerous narrow markets for the Internet – one for each technology cross-tabbed by the way content is distributed (free or paid for), and found the joint venture prospectively 'dominant in the market for WAP multi-media'. In *Vodafone/Mannesmann*²⁷ the Commission slid close to claiming that the merged entity had a dominant position in a market which did not yet exist, while failing to show that it would be dominant in one that did!

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25 C. Veljanovski, *EC Antitrust in the New Economy – Is the European Commission's View of the Network Economy Right?* *European Competition Law Review*, 2001, Vol. 22, pp. 115-121.

26 Case COMP/JV.48 *Vodafone/Vivendi/Canal Plus* [2000].

27 Case COMP/M.1795 *Vodafone Airtouch/Mannesmann* [2000].