

CLEC seminar series

**The test for economic regulation in
European telecoms**

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OUTLINE

A. Four steps to impose economic regulation

B. The three criteria test to select market

1. The content of the test
2. Implementation and standard of proof

C. The SMP test to select operators

1. Single SMP
2. Collective SMP

D. Relationship between the three criteria test and SMP

E. Conclusion

Four steps to impose regulation

1. EU screening	3 criteria test SSNIP test	Commission Recommendation
1bis. National Screening	3 criteria test SSNIP test	Possible Commission veto
+ <i>Emerging market</i>	<i>No inappropriate selection</i>	
2. Market analysis	No effective competition = SMP = Dominance	Possible Commission veto
3. Remedies	At least one Mainly behavioural Proportionate	Possible Commission comments

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Legal basis of the test

- Article 15(1) of the Framework Directive states that:
 - *The [Commission] Recommendation shall identify (...) those product and service markets within the electronic communications sector, the characteristics of which may be such as to justify the imposition of regulatory obligations set out in the Specific Directives.*
- Recital 27 of the Framework Directive is a bit more explicit by stating in a generic way that:
 - *It is essential that ex ante regulatory obligations should only be imposed where (...) national and Community competition law remedies are not sufficient to address the (competitive) problem.*

Legal basis of the test

	Sector regulation SMP	Sector regulation Interco	Antitrust Ex ante	Antitrust Ex post
Objectives	Mimic or increase competition Market structure not satisfactory Longer term view		Maintain (or increase) competition →Market structure satisfactory →Short term view	
Burden Proof	<u>1a. Market selection</u> 1b. Market def <u>2. Dominance/SMP</u>	- Control access to end-users - Necessary to ensure end-to-end connectivity	1a. Notified concentration 1b. Market def <u>2. SLC</u>	1. Market def 2. Dominance <u>3. Effect of anti-competitive conducts</u>
Remedies	Mainly behavioural	Behavioural	Mainly structural	Mainly Behavioural, Fines Damages

Legal basis of the test

- Sector regulation deals with market structures that are not satisfactory whereas competition law deals with satisfactory market structures (under Article 82 EC, a dominant position is not condemned)
 - Sector regulation should focus on structural market failures that will not self-correct
- The burden of proof for an intervention under sector regulation on *a selected market segment* is lower than for an intervention under competition law
 - Sector regulation should focus on segments where the risks of type I errors (false condemnation) is low and the risk of type II errors (false acquittal) is high

Commission's view

(Recommendation 2007/879)

1. *Static* - Barriers to entry that are high and non-transitory

- Structural barriers

 - Absolute cost advantages, substantial economy of scale and/or scope, capacity constraints, high sunk costs, control of legacy infrastructure that is difficult to duplicate

 - Examine whether industry has entry that is sufficiently immediate and persistent to limit market power (not small scale entry), examine the minimum efficient scale of production

 - Network externalities, in particular externalities created by the calling party pays principle

- Legal or regulatory barriers

 - Limits in the granting of right of ways or right of use of frequencies, without secondary trading

 - Non-profitable market entry by legal requirement: Tariffs not rebalanced

- To be assessed within the timeframe (2-3 years) of the market review and in the context of the modified Greenfield approach i.e. without taking account of regulation under review

Commission's view

2. Dynamic - Market structure which does not tend towards effective competition within the relevant time horizon

Sufficient number of undertakings with diverging cost-structure and facing price elastic demand

Excess capacity or no expansion barriers

Technological change (e.g. convergence): innovation threat from competitors not yet in the market

→ Change in market shares and falling prices

- To be assessed beyond the timeframe of the market review

Commission's view

3. Insufficiency of competition law alone to adequately address the market failure(s) concerned

Remedy can not be imposed under competition law (e.g. some access obligations or cost accounting requirement)

Extensive compliance requirement (monitoring of costs or technical parameters)

Frequent and/or timely intervention is indispensable

Creating legal certainty is of paramount concern (e.g. multi-period price control)

NOT difference in term of resources needed under both set of rules to impose remedies

BUT this criterion is redundant, imprecise, not applicable at this stage of the analysis

National regulators' views (ERG Guidance of 2008 and practice)

- Barriers to entry
 - Economies of scale and economies of scope, sunk costs or significant investment, control of infrastructure not easily duplicated, insufficient wholesale remedies
- No tendency towards effective competition
 - Potential competition, presence of large number of alternative operators, countervailing buying power, evolution of market shares
 - To be assessed within the timeframe of the review
- Insufficiency of competition law remedies
 - Degree of difficulty to address non-competitive behaviour
 - with regard to abusive conducts: denial of access, discrimination and vertical leveraging, excessive prices
 - and with regard to remedies: that can not be imposed efficiently by competition law: reference offer, accounting obligation

My view

The selection criteria should focus on market structure that are not satisfactory from a welfare point of view and that will not self-correct

Hence, should focus on the cause of market power and on its level

Should NOT focus on the type a abuses that may be done and the way that have to be remedied

Should NOT focus on institutional elements

My view

1. Barriers to entry

- Structural/non strategic
 - Behavavioural/strategic may efficiently be dealt with by antitrust
 - Legal barriers should be dealt with a change in the regulation (advocacy role of the antitrust and telecom authorities)
- High
 - But how high is high ?
 - To determine with benchmarking and cost analysis
- Non-transitory

2. Dynamic: market will not self correct in the medium run

- Regulators should assess whether the market would self-correct and deliver the results of dynamic competition (i.e. innovation) in the medium run, in particular regulators should assess whether the market delivers the benefits of the Schumpeterian creative destruction

NO additional criterion

My view

	Structural/non-strategic	Behavioural/strategic
Excessive market power	<p><i>Cell 1: fixed broadband</i></p> <ul style="list-style-type: none"> - High and sunk fixed with uncertainty - Absolute cost advantages (switching costs, legal barriers) 	<p><i>Cell 4</i></p> <ul style="list-style-type: none"> -Exploitative abuses: excessive prices -Exclusionary abuses: vertical and horizontal leveraging: anti-competitive price squeeze
Externality	<p><i>Cell 2: fixed and mobile termination</i></p> <ul style="list-style-type: none"> - Network effects - Two-sided markets 	<p><i>Cell 5</i></p> <ul style="list-style-type: none"> - Strategic network effects like loyalty program or tariff mediated externality
Information asymmetry	<p><i>Cell 3: mobile international roaming</i></p>	

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Commission's view

- Implementation of the test
 - NRAs should not re-conduct the TCT on markets selected in the Recommendation because the Commission has already applied the test
 - NRAs should apply the TCT if they want to regulate a market not selected in the Recommendation

BUT this is a fiction: The Commission is not able to apply the TCT: it has no sufficient information and it select markets for a representative hypothetical Member State

Proof ? On some markets selected by the Commission (because of TCT), the NRA did not find SMP

- Standard of proof
 - Ambiguous: in some cases, the Commission requires a heavy standard (PT/205/154), whereas in others it requires a light standard (MT/2006/389)

National regulators' views (ERG Guidance of 2008 and practice)

		Market should be regulated <i>ex ante</i> according to NRAs	Market should NOT be regulated <i>ex ante</i> according to NRAs
Market included in the 2007 Rec.		NRA should not assess TCT, but remain free to so do (scenario 1)	NRA should assess either TCT or SMP (scenario 2)
Market excluded from the 2007 Rec.	Market was included in the 2003 Rec.	NRA should perform TCT, with no higher burden of proof than SMP (scenario 3)	NRA should assess either TCT or SMP (scenario 4)
	Market was not included in the 2003 Rec.	NRA should perform TCT, with higher burden of proof than in scenario 3 and still no higher burden of proof than SMP (scenario 5)	

My view

- Implementation

- NRA should conduct TCT on every market that they want to regulate to give an *effect utile* at Article 15 FWD
- If it is not the case,
 - An regulated operator may go to national Court
 - The standard of review of the Court may be stricter than dominance assessment because the issue to be adjudicated is the choice between two legal instruments (sector regulation or competition law)
 - The Commission may veto the draft decision if it affects the trade between MS and creates a barrier to the single market or violates Community law
 - NRA are subject to Article 15 FWD
 - Article 7(4) allows for veto on market definition (and selection)

My view

- Standard of proof
 - Should be higher than SMP to give an *effet utile* to Article 15 FWD and more generally to the rationale of sector regulation
 - Should be higher to regulate than to deregulate: no symmetry (rationale of the Court of Justice, Case SonyBMG C-413/06P, for Article 2 of the Merger Regulation can not apply for Article 15 FWD)
 - Should be the same if the market has never be selected by the Commission or has been selected in 2003 but removed in 2007

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Commission's view in competition law (Guidance on Article 82 of 2008)

1. Market position of the dominant undertaking and its competitors

Market share (>40%) and stability over time

2. Barriers to entry and expansion

- Legal (i.e. imposed by the State)

Tariff or quotas

- Structural (i.e. resulting from the market structure)

Economies of scale and scope, privileged access to essential inputs or natural resources, important technologies or an established distribution and sales network, network effects

- Behavioural (i.e. manufactured by the dominant firms)

Make significant investments which competitors would have to match, conclude long term contracts with its customers that have appreciable foreclosing effects

3. Countervailing buyer power

- Customers' size or their commercial significance for the dominant undertaking, ability to switch quickly to competing suppliers, to promote new entry, or to vertically integrate

Commission's view in sector regulation (Guidelines on SMP of 2002)

1. Market position of the dominant undertaking

Market share (> 25%) and stability over time

2. Barriers to entry and expansion

Barriers to expansion, absence of potential competition, economies of scale/scope, control of infrastructure not easily duplicated, technological advantage or superiority, developed distribution and sales network, privileged access to financial resources, products/services diversification, vertical integration

3. Countervailing buyer power

National regulators' views

(ERG Revised Working Paper on SMP of 2005 and practice)

- Main criterion: market share
 - > 60 % : presumption of SMP, save exceptional circumstances
 - < 40 % : presumption of no SMP
- Direct counteracting criteria
 - Sufficient alternative infrastructure (no control of infrastructure no easily duplicated)
 - High switching cost (alternative provider or self-provision)
 - Sufficiency of wholesale remedies to remove entry barriers
- Corroborating counteracting criteria
 - Falling price and/or prices below the EU average
 - Overall size of operators
- Not very important criteria
 - Vertical integration, potential competition, technological advantage or superiority, privileged access to financial resources

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Commission's view in sector regulation (Guidelines on SMP of 2002)

1. Focal point

- Transparency, market concentration, homogeneous product, similar cost structure, similar market share, links between undertakings

2. Retaliatory mechanism

- Retaliatory mechanisms, mature market, lack of technological innovation, mature technology, moderate growth on demand side, low elasticity of demand, absence of excess capacity, high barriers to entry, lack or reduced scope for price competition

3. Reactions of outsiders

- Lack countervailing buying power, lack potential competition

National Regulators' view

- Apply the same criteria as those proposed by the Commission
- Mainly market 15/2003 (MACO), but also market 17/2003 (roaming), market 12/2003 (bitstream), market 18/2003 (media infrastructure)
- Two focal points
 - Price –related common policy
 - Access related common policy
- Possibility to have collective SMP at the wholesale level without having SMP at the retail level
- More players in SMP (3 to 5) than in antitrust collective dominance cases (50% of cases are 3 ->2 mergers and 35% of cases are 4 -> 3 mergers)

My views

- *Pros*
 - Sector regulation intervention is justified when consumers welfare is not maximised
 - Low(er) risk of type I error than antitrust as regulator have a good knowledge of the market
 - Regulator can deal with unsatisfactory market structure and can impose appropriate remedy
- *Cons*
 - Low risk of type II error (false acquittal) because collusion is intrinsically unstable, esp. without facilitating practices
 - High cost of type I error esp. in dynamic markets
- *On balance*
 - Regulators should rely on collective dominance only as a last resort
 - Should try to look for other solutions before
 - French MACO: explicit collusion
 - Spanish MACO: could allocate spectrum differently

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Commission's view

- Commission does not compare both tests:
 - TCT focuses on the general structure and characteristics of a market in order to identify those markets
 - SMP focuses on the market power of a specific operator in a given market
- In some cases (e.g. PT/2005/154), the Commission seems to imply that standard of proof of TCT is higher than SMP, whereas in other (e.g. SE/2006/341), it considers that standard of proof of TCT is lower than SMP

National regulators' views (ERG Guidance of 2008)

- Standard of proof and the level of details for assessment of the three criteria is not higher than the burden of proof necessary to show the existence (or absence) of SMP

My view

- TCT is stricter than SMP as it aims to identify the subset of the dominance cases where competition law would be insufficient to police market power because of structural market failures
- Sequence of steps to impose regulation is awkward because logically the TCT (with is stricter) should be performed before the SMP/dominance test (which is looser)
- This peculiarity is linked to the division of power between the European and the national levels

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Conclusion

- NRA have to apply the selection test to give an *effet utile* at Article 15 FWD
- The test should focus on the cause of market power (structural) and on its levels (very high), not the type of abuses nor institutional elements
- The selection test should be stricter than SMP.
- If those rules are not respected by an NRA, the Commission may veto the draft Decision of the NRA under some conditions and the an operator may appeal the decision to a national Court

Conclusion

“One of our concerns with current regulatory reforms is that, beyond the liberalization and free-market rhetoric, one may be creating an environment that will lead to heavy-handed regulatory intervention”

J.J. Laffont and J. Tirole (2000, p. 141)

“In what was ostensibly introduced as a system for organizing the transition from sector regulation to competition policy wherever possible, we have mainly seen the imposition of additional sector specific regulation”

M. Hellwig (2008, p. 26).

Thank you

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