

# The Three Criteria Test - How to get it right?

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# Agenda

Theoretical Framework

Relationship between Three Criteria Test and SMP Analysis

Application of Three Criteria Test



# Theoretical framework – ex-ante regulation only in case of market failure

- Monopolistic bottlenecks as justification for ex-ante regulation
- 2 Conditions must be fulfilled:

## ① Natural monopoly (subadditivity of costs)

- especially the case in industries with high fixed costs and subsequent economies of scale

## ② (Non-)contestability of natural monopoly

- especially the case with high sunk costs
  - market exit rather costly
  - Incumbent has already incurred sunk costs – rational to ignore (parts of) sunk costs in case of third party market entry and set prices below the point at which new entrant can recover costs

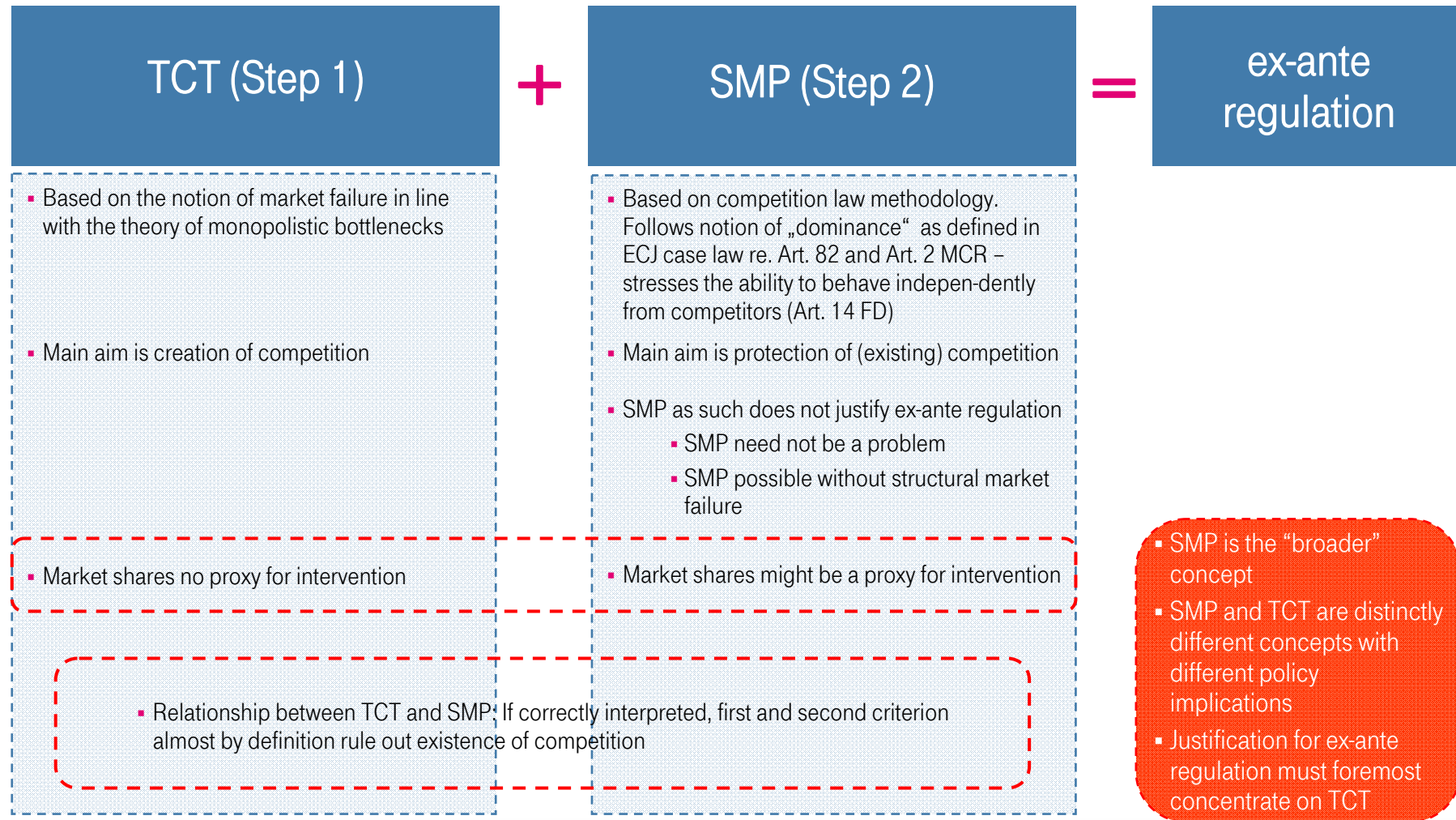


# Is the TCT in line with the theoretical framework? – Answer is Yes!

<p><b>Justification for ex-ante regulation</b></p> <ul style="list-style-type: none"><li>▪ NRF makes no explicit reference to the theory of monopolistic bottlenecks</li><li>▪ Instead: “There is a need for ex-ante obligations in <i>certain circumstances</i> in order to <i>ensure the development of a competitive market</i>” (Rec. 25 FD)</li></ul>	↔	<p><b>Assessment</b></p> <ul style="list-style-type: none"><li>▪ Focus is not on current state of competition but whether structural (or legal) obstacles prevent development of competition in the future <input checked="" type="checkbox"/></li></ul>
<p><b>The Three Criteria</b></p> <p>1. High and non-transitory barriers to entry</p>	↔	<p><b>Assessment</b></p> <ul style="list-style-type: none"><li>▪ Test on contestability <input checked="" type="checkbox"/></li></ul>
<p>2. No tendency towards competition</p>	↔	<ul style="list-style-type: none"><li>▪ Could be a test on natural monopoly but most probably a test criterion on the possibility of competition in (tight) oligopolistic markets <input type="checkbox"/></li></ul>
<p>3. Insufficiency of competition law</p>	↔	<ul style="list-style-type: none"><li>▪ 3rd criterion distinctly different<ul style="list-style-type: none"><li>▪ a <b>remedy</b> instead of a test criterion for structural market failure</li><li>▪ “re-insurance” of ex-ante regulation as a remedy of last resort <input checked="" type="checkbox"/></li></ul></li></ul>



# TCT is the important threshold for justifying ex-ante regulation



# Despite its importance, application of the TCT in practice rather limited

- “For those markets listed, the Recommendation creates a presumption for the NRA that the three criteria are met and therefore NRAs do not need to reconsider the three criteria.” (COM Explanatory Note, p.11.)

Regulatory approach used by NRA in 1<sup>st</sup> round of market analysis (ERG, 2008, p.22)

		Market in Recommendation	
		3 criteria only	SMP analysis only
To regulate		not applicable	
		13 countries !	
		6 countries	
		Market in Recommendation	
		3 criteria only	SMP analysis only
Not to regulate		5 countries	
		11 countries !	
		4 countries	

SMP analysis *de facto* substitute for TCT  
Even if TCT is carried out, focus is mostly on SMP (e.g. in Germany)

- TCT by COM only cursorily and for artificial average European telco markets
- Focus on SMP by NRAs pushes whole analysis into wrong direction
- Build in bias for overregulation (i.e. strong focus on market shares) – SMP alone does not justify ex-ante regulation
- Leads to some rather “strange” results. Examples:
  - Denmark ex-markets 3 and 4: SMP for TDC but no remedies
  - Austria market 5: Nationwide SMP for TA but competition problem (and remedies) only in certain areas
  - Germany ex market 15: No SMP although TCT fulfilled




# 1<sup>st</sup> criterion: High and non-transitory barriers to entry

Key prerequisite for existence of monopolistic bottlenecks: “[T]he underlying source of most of the competitive problems related to market power in communications markets”. ERG, 2006, p.16.

- Definition Stigler: „ a cost of producing (...) which must be borne by a firm which seeks to enter an industry but which must not borne by firms already in the industry.“
- No barriers to entry, eg:
  - economies of scale,
  - product differentiation,
  - (amount of) capital required,
  - reputation, brand image, goodwill,
  - ...

- Description COM: „ Structural barriers to entry result from original cost or demand conditions that create **asymmetric conditions** between incumbents and new entrants **impeding** or **preventing** market entry of the latter. For instance, high structural barriers may be found to exist when the market is characterised by substantial economies of scale and/or economies of scope **and** high sunk cost. (...) a related structural barrier can also exist where the provision of service requires a network component that **cannot be** technically **duplicated** or only duplicated at a cost that makes it uneconomic fir competitors.” (Recital 11 Market Recommendation)

- COM focuses on sunk costs  (but why mention scale economies at all?)
- Notion of “duplication”: What does it mean? (Quality and quantity of duplication; time span?)
- How to operationalize 1<sup>st</sup> criterion?
- COM proposes empirical analysis: *“it must be examined whether the industry has experienced **frequent** and **successful** entry and whether entry (...) is likely in the future to be sufficiently **immediate** and **persistent** to limit market power.”* (COM Explanatory Note, p.49.)
  - According to critical rationalism, empirical evidence can always only falsify but never verify
  - No entry no proof of existence of barriers to entry
  - Entry in country A but no entry in country B although market conditions are comparable – evidence of no barrier to entry in B?
  - Incentive for strategic gaming
  - “Frequent” and “immediate” implies notion of “hit and run” entry. Nearly impossible in industries with large fixed costs.
-  Concept of “committed entry” developed in US antitrust law more adequate - any justification for “ladder of investment”?
- Guidance on **analytical** analysis is completely missing
- Legal/regulatory barriers to entry no justification for ex-ante regulation – change the rules instead
  - Not applicable in mobile markets re. scarcity of spectrum given market based allocation mechanism a/o tradability of spectrum



## 2<sup>nd</sup> criterion: No tendency towards competition

- 2<sup>nd</sup> criterion basically relates to possibility for competition in (tight) oligopolistic markets
- Based on “structure → conduct → performance” paradigm
  - But relevance of structural criteria as proxy for level of competition still heavily debated

Assessment of market outcome by COM: No regulation if “market tends towards an effectively competitive outcome within the relevant time horizon”. May be the case if a “sufficient” number of firms have “diverging cost structures” and are facing “price elastic market demand”



„In such markets, market shares may change over time and/or falling prices may be observed.“ (Rec. 12 MR)

1. Fundamental objection: Reference for judging market outcomes as either bad or good? – “nirvana approach”
2. Practical objections:
  - “diverging cost structures” rather a sign for non-competitive markets (with homogenous products, competition will force all players to adopt efficient production methods)
  - “tendency towards competition” – how to measure
    - market exit positive or negative?
    - rising prices good or negative?
    - changes in market shares? – Problem of “reverse causality”, i.e. lower prices of one company might lead to higher market shares (is that good or bad?)
  - “relevant time horizon”?
    - Wrong answer by ERG: *“As a forward-looking approach involves assumptions that are not easy to forecast, a shorter timeframe reduces the risk of committing assessment errors”*. (ERG, 2008, p. 3)
3. Further guidance urgently needed. Should draw on experiences made in merger control proceedings:
  - Prices and market shares of at least the last three years
  - Technological developments – potential product substitutes
  - Potential competition



## 3<sup>rd</sup> criterion: Insufficiency of competition law

- Not an „economic“ criterion, but an efficiency test re. adequacy of existing set of competition law rules
- Not a static, “observing” criterion but a dynamic criterion – man made rules can change over time

### Theory

Competition law interventions are unlikely to be sufficient where the **compliance requirements** of an intervention to redress a market failure are **extensive** or where **frequent and/or timely intervention** is indispensable. (Rec. 13 MR)

### Practice

- In practice no thorough analysis by NRAs
- Taken as a *carte blanche* for necessity of ex-ante regulation
- Example: In Germany “analysis” consists of copy and paste. It is assumed, that criteria are always met.

- How to demonstrate insufficiency of comp. law if it hasn't been tried before? – (Limits) of essential facilities doctrine?; deterrent effect of comp. law?
  - Scope of 3<sup>rd</sup> criterion: Only structural conditions tested by the 1<sup>st</sup> (and 2<sup>nd</sup>) criterion – for all non-structural problems comp. law by definition sufficient. (Otherwise logic of TCT would make no sense.)
    - predatory pricing
    - limit pricing
    - fidelity rebates and bundled rebates
    - product differentiation and advertising
    - tying
    - exclusive dealing arrangements
    - refusal to supply
- Strategic behaviour must not be covered by 3<sup>rd</sup> criterion



Questions?

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