

Telecom Mergers & Costs

The Perplexing Treatment of Costs and Competition by the MTF

The role of cost reductions arising from a proposed merger plays an uncertain role in EU merger policy affecting the telecommunications sector. Cost reductions do not justify a decrease in competition, but they may lead to a decrease in competition if recent statements by the EU Commission's Merger Task Force (MTF) are taken at face value. This even when the MTF has concluded that the merging parties are in separate geographic markets, and therefore their activities do not, or will not subject to agreed divestments, overlap. Perhaps the most confusing aspect of this recent development has been the debut of the vaguely defined concept of "network externalities" or "effects". As used by the MTF this seems to be a supply-side concept related to economies of scale, and a concern that the merged party will enjoy permanently lower costs which indirectly raise the costs of its rivals. Is this a genuine concern?

Nature of Costs Savings

First, there is a definitional inexactitude, or rather a lack of definition. The MTF has been vague about the nature of these costs. The US Federal Communications Commission (FCC) has been less reticent. In its recent approval of the *Vodafone AirTouch/Bell Atlantic* wireless merger it identified "*economies of scale from the consolidation of billing and management, pooled equipment purchasing, joint research and development, sharing of operational support systems, more cost-effective advertising, and reduced customer churn.*" Most of these arise from reduced overhead costs and are not exclusive to either telecommunications mergers or network industries. They simply do not fall under the heading of "network externalities" implying some peculiar feature to telecom mergers.

No Evidence of Technological Scale Economies

The MTF might have in mind a more specific scale economy - technological economies of scale generated by the an expand geographic coverage or larger "footprint". However, the existing statistical evidence does not provide support for the existence of such scale economies in the fixed and especially in the wireless sectors. Thus a merger between parties with no overlapping activities which leads to a geographic expansion of the physical network is unlikely to give rise to significant scale economies and hence barriers to entry.

The issue is complicated and confused by two other considerations

Economies of Density

The first is that all networks have falling unit costs when traffic volumes increase. This is because they have high fixed costs from building the network. However, these are not economies of scale but economies of density. Economies of scale arise (loosely speaking) when the unit costs decline as a network's footprint or capacity increases or more specifically a bigger network has lower unit costs than a smaller network for similar volumes of traffic. Economies of density arise when the average unit costs decline *for a given network size as the volume of traffic grows*. However, again this is a characteristic of any industry with substantial fixed costs. There is no necessary implication from the presence of economies of density that either a merger will be anti-competitive or that the merged entity will have lower unit costs which cannot be replicated by its competitors.

Indirect Effects

To be fair the MTF's analysis and concerns are subtler focusing on the interaction between supply and demand effects. The claim appears to be that because the merged network offers a superior geographic coverage and is able to internalise previously external interconnection costs, it will attract more customers and thereby generate more traffic (*Telia/Telenor*). It therefore gains an advantage which its rivals do not, and by implication cannot. However, apart from this begging several very basic questions - Is enhanced geographic coverage a significant demand driver? Are the consequent economies significant? Do the alleged competitive advantages weaken competition? - it is doubtful whether this raises entry barriers or is a non-replicable by other operators. In many sectors there are multiple networks (mobiles) and later entrants have the advantage of using cheaper and better technology.

Conclusion

Notwithstanding this, the MTF's tendency to use cost considerations to identify potential reductions in competition is not well developed and confused. Greater clarity is in needed if network externalities are not to become a complainants' charter.

EU 1999 Communications Review

Why Adding Dominance to SMP just Won't Do.

As part of the EU Commission's 1999 *Communication Review* the DG Information Society has suggested that the little loved concept of Significant Market Power (SMP) under the Interconnection Directive (ICD) be complemented by the competition law concept of dominance. Many have argued that SMP with its 25% market share be abandoned completely in favour of the competition law test of dominance with a 40-50% market share. DG Information Society appears to have taken this on board by proposing that both dominance and SMP be used to frame *ex ante* regulation of the telecommunications sector.

This compromise will not resolve the difficulties of SMP. First, there is confusion over how SMP should be applied. Some NRAs (OFTEL) insist that SMP is not related to dominance or is competition law test while others, including the EU Commission now, suggest that the 25% market share was always intended as a rebuttable presumption which required a competitive analysis, and therefore could be modified to something resembling dominance. Consistency is obviously needed.

Second, SMP and dominance are unduly narrow concepts. Dominance requires the calculation of a market

share in the relevant market which is defined in terms of consumers' reaction to small price changes i.e. it is a short-term demand-based concept. Competition in telecom markets, at least the competition the DG Information Society wants to foster, has more to do with supply-side factors – more operators and more networks. Dominance and SMP ignore entirely long term cost efficiency considerations and investment incentive effects when used as a trigger to impose *ex ante* regulation. They focus on the impact on competition, while failing to systematically incorporate the impact that various access and pricing rules have on the incentive of operators to build/upgrade networks.

A Modest Proposal

The EU Commission should scrap SMP and dominance entirely as a trigger for *ex ante* regulation in favour of a standard which has as its central consideration the impact on long term development of competition and efficiency in network usage and investment. This could take the form similar to that used in Australia under the *Trade Practices Act* – a broader test of the Long Term Interest of End User, which systematically takes into account competitive and efficiency effects.

© Case Associates 2000

CASE ASSOCIATES

are an economics practice providing advisory, strategic, and economic assistance in competition and regulatory proceedings. A description of Case's services and earlier Casenotes can be found at www.casecon.com. For further information or to discuss a specific assignment contact:

Dr. Cento Veljanovski on + (44) (0) 20 7376 4418 or cento@casecon.com