CASENOTE

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COMPETITION & REGULATORY ECONOMISTS

Economics of Competition & Regulatory Issues

October 2001

Regulating with Competition Law

Why the proposed use of dominance to trigger EC telecommunications regulation is flawed

The EC Commission has now accepted that the guiding principles for ex *ante* regulation should be the same as competition law. The draft *Framework Directive* adopts the competition law test of dominance (40%-50% market share as a rule of thumb) to replace the little loved 25% threshold of Significant Market Power (SMP) under the *Interconnection* and *Licensing Directives*. However, the basis and operation of this "regulatory convergence" is flawed. The unmodified application of competition analysis does not constitute an adequate access and interconnection regime. This is principally due to the Commission's failure to base telecommunications regulation on the goal of maximising consumer welfare.

The Commission's proposals

Under the proposed regulatory package ex *ante* regulation will be imposed on operators who are dominant, which confusingly is also called SMP. Determining dominance will be undertaken by the EC Commission in accordance with the principles set out in the draft *Market Analysis Guidelines*. These mirror those under competition law. National Regulatory Authorities (NRAs) will have scope to determine the geographic market within each Member State, and undertake competitive assessments to determine whether operators are dominant within the pre-defined product and trans-national markets identified by the EC Commission.

Failure to incorporate dynamic efficiency

The draft *Framework Directive* requires NRAs to promote open and competitive markets; economic efficiency; create appropriate incentives for investment and innovation; develop internal markets; and promote the interests of European citizens. This goes much further than competition law which pays little attention to these dynamic efficiency goals, and indeed excludes consideration of these for fear of encouraging old style industrial intervention. Yet most surprisingly, the draft *Market Analysis Guidelines* take no direct account of investment incentives and efficiency considerations in assessing market power. Since access and its price cannot be divorced from a network operators' ability and incentive to investment in infrastructure, providing appropriate incentives for investment and innovation are important. In short, the unmodified adoption of market analysis from competition law does not implement the *Framework Directive*.

Undue short termism

The short-term nature of the competition law approach also clashes with the *Framework Directive's* goals. Under EC competition rules, the analysis looks at changes likely to occur within one year. This seems the position under the *Framework Directive*. Further, it is proposed that annual reviews will assess whether SMP status is warranted in the light of changing market conditions. That is, a short time period will be used to trigger *ex ante* regulation. This cannot be consistent with the objective of using *ex ante* regulation to deal with instances of permanent market power, or statements that market definition under the *Framework Directive* should be prospective and forward-looking. The Commission itself notes that in determining dominance in dynamic markets, a period longer than three years may be insufficient.

The proposed annual reviews of SMP jar with the requirement that *ex ante* regulation should provide a stable backdrop for investment and innovation. Annual reviews will result in persistent regulatory uncertainty, and reflects an odd trade-off between the need to avoid regulatory obsolesence and certainty. Indeed, if there is genuine concern that SMP designations will be overtaken by changing market conditions within a year, then it is doubtful that the Commission has correctly identified the need for *ex ante* regulation in the first place!

Dominance is an inappropriate trigger

Dominance is an inadequate trigger for *ex ante* regulation. It is defined as the ability of a network operator to act independently of its competitors and customers i.e. an operator with market power. This test has a number of defects. First, it will generate excessively narrow market definitions. Markets are defined in competition law as the narrowest set of products which would constrain the price increasing ability of a firm, and therefore tend to ignore other products which have a similar constraining effect or a different set of products which would also constrain price-setting behaviour. Second, the test is not followed by the Commission itself. In recent merger decisions involving network operators, the EC Commission has significantly downplayed the standard market definition/dominance approach, relying more on dynamic interactions between vertical and horizontal links in the supply chain. Third, dominance is seen as a flawed test

and replaced in most advanced antitrust laws by that of *"substantially lessening competition"*. For example, the UK Government following "best practice" plans to adopt the latter test for its new merger law. These factors suggest that regulation of the communications sector is achieving consistency with an outmoded competition standard; one not even adhered to by the EC Commission in its enforcement of competition law!

Centralises market pre-definitions

There are serious concerns about the proposal to centralise and pre-define markets by the EC Commission. In competition law, markets and dominance are based on detailed case-by-case assessments. Under the draft *Framework Directive*, the EC Commission will pre-define product markets on a Community-wide basis each year. There is no reason to suppose that this will generate meaningful market definitions, especially when most markets will be national in character. This urge for harmonisation is likely to lead to excessive regulation which does not reflect market conditions. It may also result in a lack of consistency as NRAs seek to adjust to the centralisation of market definition by adopting differing market share thresholds to trigger SMP. Alternatively, the system could degenerate into a highly centralised formalistic system where SMP is found by NRAs using pre-defined markets and pre-determined market shares.

Ignores regulatory costs/effectiveness

There is no serious consideration of the effectiveness and costs of telecommunications regulation. Once SMP has been determined, NRAs can impose a range of obligations on network operators including mandatory access, cost-based tariffs, non-discrimination, etc. It is not self-evident that these will generate sustainable increases in consumer welfare. That there are reservations about the effectiveness of some of these regulations can be seen by the differing approaches taken by NRAs over the mandating of access to mobile networks – some have imposed mandatory access sometimes at cost-oriented tariffs; while other NRAs have concluded that open access will not generate significant consumer welfare gains and/or stifle innovation and reduce investment.

A regulatory mismatch

The unmodified use of competition law analysis to frame *ex ante* regulation is flawed because it:

1. does not distinguish between short-term market power and long-term persistent market failure. The law will therefore be overinclusive in the sense that it will regulate some activities which need not be regulated and/or impose remedies which do not produce permanent increases in consumer welfare;

2. omits dynamic efficiency factors and therefore risks damaging sustainable competition;

3. does not foster regulatory certainty; and

4. does take into account the costs and effectiveness of proposed regulatory options.

The EC Commission's approach is flawed because it has not set up a robust consumer welfare (cost-benefit) model of regulation. As a result it promotes a simplistic version of competition which has an uncertain relationship to sustainable effective competition that increases the longterm welfare of consumers. In order to remedy this, the factors identified above will need to be addressed and systematically incorporated into the practical application of the *Framework Directive.*

This Casenote is based on a talk given by Cento Veljanovski to the European Media Forum's seminar "Regulating Telecoms – Recent Lessons and New Opportunities" British Academy, London, 26th September 2001.

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