The Paradox of EU Mobile Regulation

a report by

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Although mobile telephony is at the cutting edge of competitive developments in the telecoms sector, regulation is increasing. The general push for technology-neutral regulation and open access has seen mobile network operators increasingly under threat, exacerbated by the recent Universal Mobile Telecommunications System (UMTS) auctions that have massively increased the industry's debt. The once glamour stocks of the telecoms sector are now treated with caution.

The Mobile Paradox

The mobile sector confronts a paradox – as competition increases so does regulation. Normally there is an inverse relationship with competition seen as a substitute for regulation. Ideally, regulation should only be used as a last resort in the face of significant market failure. Nonetheless, regulators have become increasingly impatient, arguing that the mobile sector is not fully competitive, is characterised by a number of bottleneck monopolies, and that tariffs are too high.

Price Controls

National and EU regulators have been concerned with the high price of mobile telephony relative to (regulated) fixed telephony. This premium, which can be substantial, is seen as evidence of operators' market power. The source of the market power is alleged to be the presence of a bottleneck monopoly in call termination.

The calling party is not a customer of a mobile operator, yet pays for the call (calling party pays) and is seen as a captive customer of the terminating mobile operator who can charge whatever it likes. As a result, mobile termination rates have been found to be excessive and, in many countries, such as the UK, regulators have forced them down.[1]

The basis for this regulatory racketing is suspect. First, it is questionable whether there are separate markets for call origination and termination, or whether the latter is a bottleneck monopoly. If correct, the latter implies that no amount of competition between operators, whether fixed or mobile, can constrain the pricing power of terminating operators, which seems far-fetched.

There are strong reasons why call termination cannot be treated in isolation from the rest of the mobile sector. Mobile telephony is a relatively immature sector. While growing rapidly, it has penetration rates below 50% in most of the EU (and far less when many of these inquiries were undertaken several years ago). In this environment, and because of the existence of network effects and need for fixed-cost recovery, it does not follow that prices should be similar to fixed telephone charges. Moreover, one cannot assess charges for one type of service in isolation from the whole mobile package.

The implicit assumption of the termination-as-a-bottleneck theory is that people demand inbound calls only. The reality is that wireless networks are constructed to offer two-way communications, which is what is demanded of them. The demand by inbound and outbound (subscribers) callers is therefore interdependent with all parties effectively purchasing a bundled service. Often these callers do not represent two distinct classes of customer but form part of the same economic or calling group. As a result, inbound and outbound charges are set in some relationship to one another

Network effects provide another economic justification for relatively higher termination charges. A network effect is said to exist when a network's value is enhanced by the number of people connected. As a result, the social value of an additional subscriber exceeds his or her valuation

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1. *Monopolies and Mergers Commission, Reports on references under Section 13 of the Telecommunications Act 1984 on the charges made by Cellnet and Vodafone for terminating calls from fixed-line networks, December 1998; C G Veljanovski, "Competition in Mobile Phones – The MMC rejects Oftel's Competitive analysis",* European Competition Law Review, *1999, Vol. 20, pp. 205–213.*

since external benefits are conferred on others when they join the network. Thus, there is a case for subsidising take-up. While in some recent EU merger decisions, network effects have been seen as the central issue in assessing competitive pressures,[2] in the mobile sector they have been largely ignored. Yet, some work that has taken explicit account of the phenomenon, has concluded that there is economic justification for termination charges to be four to five times above unit costs.[3]

Open Access

Open access has become the mantra of the EC's 1999 Review of telecoms regulation. As a result, the mobile sector is facing increasing pressure to allow access to so-called virtual operators and to make new products available to all.[4]

Mobile markets in most countries have between three and five network operators. These networks are usually closed to third-party access, who cannot buy wholesale capacity. Virtual operators do not own networks but buy airtime and resell it to their customers under their own brand. As far as the customer is concerned, the virtual operator looks like a network operator. It is argued that in a fully competitive mobile sector, a wholesale market in bulk airtime would arise and that customers would be supplied by both network and virtual operators using the formers' networks.

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Cost-based Tariffs

The concern over the level of mobile tariffs has been further fuelled by the push to introduce cost-based prices. The EU Interconnection Directive states that operators with significant market power are required to have cost-reflective tariffs. This in turn has been regarded as tariffing based on long-run incremental costs (LRIC) on a forward-looking basis, i.e. costs that at any time reflect the best technology available.

In most countries mobile operators are immune from this requirement because they do not have the requisite 25%, or greater share of the national market for interconnection (which includes fixed interconnection). Nonetheless, regulators are pushing for LRIC to be applied to the mobile sector.

The attempt to force mobile tariffs down to LRIC costs is fraught with problems. Notwithstanding the arbitrary nature of the allocation of costs to various activities/services, prices will need to exceed marginal costs to recover fixed costs and this mark-up should be set highest where it distorts consumers purchasing patterns least i.e. for those services where demand is less responsive such as inbound calls and international roaming. Thus cost oriented tariffs run the risk of both distorting demand and slowing mobile penetration.

The claim that mandated virtual mobile network operators are self-evidently pro-competitive or necessary is questionable, and certainly has not been subject to serious analysis.

The first point to note is that government policy has been designed to foster direct network or facilities based competition. Mobile operators in each country have been required to invest in 2G national networks, and now four to six new UMTS networks. These operators have been under no explicit obligation to allow third-party access because of the investment needed. The existence of three to five 'mobile local-loop' networks in direct competition places mobile telephony at the competitive frontier of telecoms development, and a shining example of vigorous competition.

The open-access approach seeks to foster a different type of competition – service competition. The

2. MCI WorldCom, Case IV/M.1069, OJL 166/1, 4 June 1999.

3. J Wright, Competition and Termination in Cellular Networks, 25 Jan 2000.

4. This seems to be the implication of the undertaking imposed in the recent EU clearance of the Vodafone takeover of Mannesmann AG. There, the Commission required that Vodafone make available to third parties its single pan-European tariff when it was offered by Vodafone. Vodafone AirTouch/Mannesmann Case No COMP/M. 1795, 12 April 2000.

central question is whether there is a trade-off between network and service competition. This manifests itself in accusations that those pushing for open access wish to free ride on the investment made by the network operators. It is argued that this will have adverse long-term effects since it diminishes the incentive to invest in the on-going process of network rollout, maintenance, and improvement. Indeed, some potential applicants for new mobile licences have publicly stated that if open access is mandated they will not build a network but simply buy capacity from existing network operators. There is a trade-off between network and service competition, and the real possibility that open access will lead to less competition in the long run. This consideration has become more pronounced with the recent auction of 3G licences, which require massive investment.

Needless to say, this argument depends crucially on the charge made for access, since, if appropriately priced, it should not have investment disincentive effects. The issue here is that a regulatory game will emerge in which third parties seek increasingly lower prices by accusing operators of monopoly abuse.

A related issue is whether access should be mandated. Many in the industry argue that allowing third-party access under the right terms is profitable and will be commercially negotiated without the need for regulatory intervention. Already in Australia, and a number of EU Member States, operators have negotiated access arrangements without the need for regulation. However, regulators have argued that because the mobile market is not fully competitive, mobile operators will seek to foreclose the market to virtual operators.

In theory, as long as developing a wholesale market is profitable, competition between mobile operators will result in the development of such a market. There is a feeling that regulators are moving pre-emptively under pressure from those not prepared to make the necessary investment.

Conclusion

As Europe embraces liberalisation of the telecoms sector it has adopted a simplistic market view that sees low prices (even zero prices), open access and unbundling as synomous with a competitive market. This is a paradox because the development of new wireless networks stands out as the major success of a new competitive era in telecoms. ■