



**APPENDIX 1: IMPOSING ACCESS OBLIGATIONS ON
INNOVATIVE COMMUNICATIONS MARKETS: AN ASSESSMENT
OF OFTEL'S APPROACH**

A report for BT by CASE Associates

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Imposing Access Obligations on Innovative Communications Markets

AN ASSESSMENT OF OFTEL'S PROPOSALS

PREPARED

FOR

British Telecommunications

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RECOMMENDATIONS

Reasonable Requests

1. Long Term Appreciable Benefits to End-users (“LTABE”) is accepted as the overriding test for mandating access;
2. Access, or a specific remedy, should only be imposed if it leads a) to appreciable consumer benefits in the form of price competition and choice; and b) does not generate offsetting costs in the form of the likelihood of reduced investment and innovation;
3. Oftel urgently needs to clarify the relationship between LTABE and its proposals on “reasonable requests” and “undue burden”;
4. Oftel’s proposal that access can be assessed or viewed as a “wholesale market” issue is incorrect. Market definition and access must be assessed initially at the retail level to determine whether access will generate appreciable benefits to consumers; and
5. Oftel should set out a clear statement on the burden of proof and evidentiary standards it will adopt when mandating access. Given that access is intrusive regulation, expropriates private property rights, and imposes a high regulatory burden, the burden of proof must be set at a high level and be satisfied by Oftel;

Forbearance/Burden of Proof

6. Oftel should clearly state that forbearance is a key element of its enforcement procedures, and in particular it should set out its position on the asymmetric impact of Type I and Type II errors. We propose that all regulatory intervention be based on the avoidance of Type I errors, or that these be given a higher weighting than Type II errors;
7. Innovative product markets should be dealt by Oftel using its powers under the *Competition Act 1998*. They should not form part of the guidelines under the AID;
8. Clear guidelines should be set out for market definition in innovative markets;
9. Oftel should spell out how it intends to apply leveraging analysis under Article 14(3) AID for innovative products; and
10. Oftel should state that designating an operator as having SMP on a specific market on the basis of leveraged market power will be an exceptional finding.

Options Appraisal Exercise (OAE)

11. Oftel should not make a final decision over the implementation of AID until the EC Commission has completed its consultations and finalised the *SMP Guidelines*, the *Recommendation*, and any remedies guidelines, and Oftel has drafted its “*options appraisal exercise*” (“OAE”) guidelines;
12. In the absence of Oftel’s draft of the OAE guidelines we have not be able to assess Oftel’s proposals; and
13. Oftel’s OAE should contain sensitivity projections which incorporate statements as to benefits, costs, and especially error costs for each proposed remedy.

INTRODUCTION

We have been asked by British Telecommunications to provide a critical perspective on the Office of Telecommunications' ("OfTel") consultation document ("CD") *Imposing access obligations under the new EU Directives – A consultation on guidelines* (9 April 2002), specifically as it relates to innovation markets.

SUMMARY

Our view is that the CD places an unexpected emphasis on access arrangements for innovative products, and that its proposals are a significant and unjustified extension of the proposed access regime. The *Access and Interconnection Directive* ("AID")¹ deals with "*entrenched market power*" arising from barriers to entry and historical legally protected monopoly positions, not market power issues raised by dynamic product development. We have conclude that competitive concerns arising from innovative products should be left to case-by-case evaluation under the *Competition Act 1998*, which is also enforced by OfTel.

Further, we have difficulty in responding to many of the specific proposals in the CD. This is because the principles governing access are not set out but reserved for future draft guidelines on the "*options appraisal exercise*" ("OAE") under Article 12(1) AID; there are no guidelines for the appraisal of innovative markets, and the more specific proposals set out in the CD are vague and ill-defined, especially on the proposed basis for mandating access to innovative wholesale products (Q3).

BASIS FOR REGULATION

General

The package of reforms proposed by the EC Commission under the *Framework Directive*² ("FD"), and in particular AID, will have wide-ranging effects for the regulation of the communications sector. These are based on several central tenets:

1. **Regulatory convergence** - *ex ante* regulation of the communications sector is to be based on the same principles as EC competition law, in particular that dominance, termed Significant Market Power ("SMP"), will trigger *ex ante* regulation;

¹ *Directive on access to, and interconnection of, electronic communications networks and services*. 2000/0186 (COD).

² *Directive on a common regulatory framework for electronic communications networks and services* 2000/0184 (COD) approved, 4 February 2002.
http://europa.eu.int/information_society/topics/telecoms/regulatory/new_rf/documents/03672en1.pdf.

2. **“Entrenched market power”** – *ex ante* regulation is designed to deal with entrenched market power due to significant barriers to entry or incumbency of vertically-integrated operators who are assumed to have an incentive to foreclose markets to their (downstream) rivals by exclusionary abuses such as refusal to supply and discriminatory treatment;
3. **Forbearance and proportionality** – the proposed remedies only apply if competition law is inadequate, and if they are a proportionate response; and
4. **Long-Term Appreciable Benefits to End-users (“LTABE”) test** - the CD commendably states the overriding objective of the AID is consumer welfare:

“As a general rule, for regulation to be appropriate it should deliver appreciable benefits to end-users over that status quo through stimulating competition in a way that will deliver more choice for customers and/or provide greater opportunity for competitors to drive down prices.”³

Several other features of the proposed access regime should be highlighted:

1. **Greater weight to economic efficiency** - the proposed regulation gives greater weight to economic efficiency factors than competition law.⁴ These considerations are largely absent from much of competition law and, in particular, Article 82 (monopoly abuse) and merger analysis which is the most relevant to the prospective analysis of dominance required under the AID,⁵ and
2. **Access not a right** - access to the facilities of SMP operators is not a right. This is because it is recognised that there are consumer and efficiency benefits to vertical integration, and that access does not necessarily enhance either consumer benefits or efficiency. This is especially the case where investment and innovation are important, and influenced by access and access pricing arrangements. In short, when mandating access or a specific remedy, Oftel must establish that there are LTABE.

Application to Innovative Markets

We do not believe that it was intended or is the case that the FD/AID should be applied to innovative markets or products as set out in the CD. As stated above, this is an unexpected development pushing out the scope and intrusiveness of the proposed

³ CD para 2.9.

⁴ The AID (Art. 5) and FD (Art. 8) places significantly greater emphasis on economic efficiency than competition law. The AID (Art. 5(1)) states that NRAs shall exercise their responsibilities, *inter alia* in a way that “*promotes economic efficiency, sustainable competition, and gives maximum benefit to end users*”. This is reiterated in Article 13(2) on price controls. Admittedly this commitment is somewhat ambiguous. For example, it is given an apparent wide meaning in Article 5 of the AID and less so in the FD where NRAs are given the objective of “*encouraging efficient investment in infrastructure*” and “*ensuring the efficient allocation and assignment of radio spectrum*”.

⁵ Article 81(3) of the *Treaty of Amsterdam* comes closest to Article 12 (2) of AID.

access regime. Where innovative or newly emerging markets are concerned, the FD⁶ and *SMP Guidelines*⁷ make clear that a NRA should be especially cautious about prematurely and inappropriately intervening. Indeed, the EC proposals go further by excluding innovative markets from the proposed regulations. The EC Commission's draft *SMP Guidelines* state:

'By definition, the application of Article 14, paragraph 3 (Framework Directive) is excluded in relation to market power leveraged from a 'regulated' market into an emerging, 'non-regulated' market. In such cases, any abusive conduct in the 'emerging' market will be dealt with under Article 82 of the EC Treaty'.⁸

And similarly its draft *Recommendation* states:

"New and emerging markets, in which market power may be found to exist because of "first mover" advantages should not in principle be subject to ex ante regulation".⁹

Summary

In summary, the proposed framework of the FD/AID is designed to deal with "entrenched" market power. Further, and critically, access can only be mandated if it is shown to generate appreciable consumer benefits. Mandating access therefore does not automatically follow from a determination of SMP. Innovative and emerging markets, even when developed by a SMP operator, are not presumptively covered by the AID.

SOME GENERAL ISSUES

Before proceeding to a detailed assessment of the CD's proposals regarding innovative markets there are a number of general issues surrounding the proposed access regime which are important to commenting on the CD's proposals.

There is a nuance running throughout the CD that SMP operators must offer "reasonable" access to their networks even for new and innovative products. This is compounded by a number of technical and legal factors which make the proposed regulatory package "over-inclusive" and risk over-regulating the communications sector. There is a danger that unless there are adequate safeguards, these together with the proposals in the CD, could transform the proposed regulatory framework into a mandatory access regime (even common carrier regulation).

⁶ "Those guidelines will also address the issue of newly emerging markets, where de facto the market leader is likely to have a substantial market share but should not be subjected to inappropriate obligations." FD Recital 27.

⁷ *Draft Guidelines on market analysis and the calculation of significant market power under Article 14 of the proposed Framework Directive on common regulatory framework for the electronic communications networks and services* 21.02.2002 (hereinafter referred to as *SMP Guidelines*).

⁸ *SMP Guidelines* n. 92.

⁹ *Recommendation* para 14.

Over-inclusion

At the heart of many of the concerns surrounding the proposed package of reforms is that SMP is an over-inclusive standard. An over-inclusive standard is one that imposes regulatory obligations when the net benefits are zero or negative. This arises principally because SMP is based on narrow market definitions, potentially low market share thresholds, and of itself does not identify pockets of hardcore market power which cannot be dealt with by competition law. Consider these in turn.

Market definition is an essential pre-condition for the application of both competition law and now *ex ante* regulation. Market definition, as applied in competition law, is mainly based on consumers' willingness to substitute between products within a short timeframe (usually within one year).¹⁰ Further, although the various guidelines suggest that this should be based on consumer reactions to changes in relative prices, invariably it is applied using product characteristic and functionality (the "interchangeable in use test") and absolute price differentials, and often based on very little empirical evidence.

The market definition guidelines under the FD/AID recognise that a more flexible approach must be used. It thus makes clear that market definition should adopt or cover a longer timeframe were appropriate, and that SMP is forward-looking taking a reasonable view of future market developments, although how this should be done is left vague. Nonetheless, at the core of the trigger for *ex ante* regulation is a crude and relatively impressionistic analysis of market facts, expressly designed to select the narrowest possible market definition based on short-term consumer reactions and product characteristics.

Further, the Commission's *Recommendation* on pre-defined markets has proposed some extremely narrow market definitions which will find nearly every network operator as having SMP. At a superficial level SMP looks like an asymmetric system of regulation triggered by a relatively high market share (based on the concept of dominance), and subject to a number of defences. However, given the tendency for very narrow product definitions, in particular the view that because of Calling Party Pays ("CPP") the termination services of each network is a distinct relevant product market in which the network operator has a monopoly, it follows that all networks irrespective of size will be caught in the regulatory web with a blanket designation of SMP. The CD, for example, tends to contribute to the impression that markets are to be defined narrowly by confusing products with markets in its discussion of access obligations.¹¹ The perverse consequence of this is that instead of market share or SMP deciding regulatory obligations, market definition will! Clearly, this is inadequate for regulation designed to deal with entrenched market power which cannot be dealt with by competition law. This

¹⁰ EC Commission, *Notice on the definition of the relevant market for the purposes of Community competition law*, OJ C 372/05, 9 December 1997. EC Commission, *Commission Guidelines on the application of EEC competition rules in the telecommunications Sector* OJ 233, 6 Sept. 1991. Similar and more detailed guidelines have also been set out by the UK Office of Fair Trading under the *Competition Act 1998* (OFT, *Market Definition*, OFT 403, March 1999; *Assessment of Market Power*, OFT 415, September 1999; *Assessment of Individual Agreements and Conduct*, OFT 414, September 1999) and OFT/Oftel *The Application of the Competition Act in the Telecommunications Sector*, OFT 417 February 2000).

¹¹ For example CD para 2.20 "Should a product be new or untested [...] difficulties in assessing whether or not the SMP operator can expect ..." and CD para A5.3 "it may be justifiable on competition grounds to require an operator to make innovative wholesale products available".

is especially so in dynamic markets where technological innovation, investment and product development are endogenous.

Second, although the reforms brought in by the FD/AID, and reflected in the CD, have raised the nominal market share threshold from 25% to in excess of 40%, this has been weakened by other factors in competition law and reiterated in the *SMP Guidelines*. The last decade has seen a movement away from single firm dominance to concepts which enable the regulator to lower the threshold and broaden the scope of regulation. The increased prominence of collective dominance,¹² leveraged dominance, and its application to future products such as in *Vodafone/Mannesman*¹³ all have the effect of lowering the threshold for each individual operator. Further, SMP is a harsher standard than dominance because it triggers regulation, whereas under competition law it is the abuse of dominance that triggers intervention. Thus, the regulatory framework has dispensed with an important “safety value” against over-regulation in the form of a market appraisal of competitive constraints on the firm, i.e. whether given the market share there is effective competition.

The above general concerns are magnified when applied to innovative markets where supply side considerations are more pronounced. Access regulation, and especially the central premise of the CD that vertical integration inhibits effective competition, is based on a static model. Both the economic literature on access and communications, and the regulatory theory are silent on how markets for innovation and investment work, especially as they affect long run competition, and the impact of competition and regulation on the rate of innovation and investment. For example, Professors Laffont and Tirole’s impressive book on the economics of telecommunications barely mentions investment and innovation.¹⁴ Therefore, in markets where innovation and investment are central, the theory and understanding of the complex interactions between market structure, pricing and access regulation on the one hand, and their impact on the incentives to invest and innovate on the other are largely absent.¹⁵

¹² Collective dominance will have the effect of lowering the SMP threshold especially in sectors where there is direct network competition, such as the mobile sector. Thus instead of a single firm dominance of 40% plus, three or four firms with an overall 80% market share could be found collectively dominant with each operator having a market share as low as 20%-27%. The conditions conducive to a finding of collective dominance (homogeneous products, high concentration, similar market shares and structure etc) are also conducive to strong price competition, and are the same assumptions used by Ofcom in its calculations of LRIC in *Effective Competitive Review – Mobile* (Sept. 2001).

¹³ Case No COMP/M. 1795 - *Vodafone AirTouch/Mannesmann*, 12/04/2000. This is the only recent (merger) decision we are aware of, where the Commission has imposed an access requirement on a network operators (there are several on conditional access). This decision was, however, based on the fact that the Commission regarded Vodafone as the only mobile operator in the EU capable of supplying a “seamless pan European corporate service” and therefore prospectively dominant in the retail market for this service. Thus, it was the alleged uniqueness of the retail product which led to the conclusion that the network which supplied this service would be an “essential facility”, and would have an incentive and the means to engage in a vertical “margin squeeze”. Indeed, the Commission declined to make a distinction between facilities and services, as in its view this was unnecessary given the facts of the case.

¹⁴ J. J. Laffont & J. Tirole, *Competition in Telecommunications* (MIT Press 2000).

¹⁵ J. Hausman, “Valuing the effect of regulation on new services in telecommunications” (1997) *Brookings Papers on Economic Activity: Microeconomics* 1. OFT, *Innovation and Competition Policy - Economic Discussion Paper 3* (2002); W. J. Baumol, *The Free Market Innovation Machine* (Princeton UP 2002); C. G. Veljanovski “EC Antitrust in the New Economy – Is the European Commission’s View of the Network Economy Right?” (2001) 9 *European Competition Law Review* 115; C. G. Veljanovski “The Paradox of EU Mobile Regulation” in *Wireless Technology 2001*, London: World Markets Research Center, 2000; S. C.

Market definition and market power assessments based on relatively short-term responses to relative price changes do not capture the nature of competition in innovation. In such markets, non-price factors are important as are supply-side considerations such as competition between different products “for the market” rather than “in the market”, and that market power is inevitable and a key driver of greater sustainable long run competition. Further, the timeframe for innovative competition is, by definition, longer than for established products if entrenched market power is to be identified. To this must be added a general recognition that market definition and competitive assessments of emerging markets are highly speculative and particularly prone to regulatory error when used to trigger regulation. This is particularly so when the focus is on innovation and first mover advantages, where there will be a strong tendency, as reflected in the CD, to regard the innovation as the market, and the innovator as the monopolist no matter that this status may be temporary or the innovation part of a wider (changing) market.¹⁶

Access can adversely affect the incentives for a network operator to invest and innovate. Closed networks, vertical integration and limited access may be necessary to foster an optimal level of network competition, and therefore access *per se* is not [necessarily] a desirable policy.¹⁷ Further, to the extent that network investment is endogenous, access prices will have an impact on investment levels and hence on the level of network competition. The costs of mandatory access could be substantial. These include direct costs on operators, including the efficiency losses from vertical disintegration,¹⁸ administrative costs, and inefficient arbitrage. The empirical evidence is not yet strong, because although mandated access (LLU, SNA, line sharing etc) is becoming prevalent across Europe it is still too early to assess its impact, and the complexity of the issue.¹⁹

Littlechild, *Regulators, Competition and Transitional Price Controls: A Critique of Price Restraints in Electricity Supply and Mobile Telephones* (IEA 2002).

¹⁶ These issues are covered in the report to the Office of Fair Trading and Oftel entitled *Competition and Innovation Policy* (March 2002) OFT Economic Discussion paper No. 3.

¹⁷ Oftel has taken into account that access may deter investment in the past. Recently it concluded that mandatory provision of wholesale airtime to independent service providers (ISP) could provide disincentives to innovate (Oftel, *Effective Competition Review: Mobile*, 26 September 2001, para 2.47). Similarly, Oftel refrained from mandating MVNOs because of the disincentive to invest and extend existing infrastructure (Oftel, *Statement on Mobile Virtual Network Operators*, October 1999, para 2.26).

¹⁸ The main pro-competitive factors for vertical integration include: technological interdependence, reduction in transaction costs, quality control and vertical integration increases inter-network competition.

¹⁹ For example a study of US cable rate regulation showed that rate controls and access obligation led to a reduction in consumer choice i.e. cessation of types of services with loss of all consumer surplus.¹⁹ T. W. Hazlett & Spitzer Public Policy Toward cable Television – The Economics of rate Controls (AEI 1997); G. Bittlingmayer & T. W. Hazlett "Financial Effects of Broadband Regulation" (mimeo 2002) <http://www.business.ku.edu/home/gbittlingmayer/research/BroadbandReg.pdf>. Bittlingmayer's study of 21 major industries in the US covering 1947-1991 investigated the statistical association between antitrust case filings and investment. Each antitrust filing was associated with a significant decline in investment in the respective industry. G. Bittlingmayer "Regulatory Uncertainty and Investment: Evidence from Antitrust Enforcement" (2001) 3 *Cato Journal* <http://www.business.ku.edu/home/gbittlingmayer/research/cato.investment.ms.pdf>

Access may also not generate appreciable consumer/end-user benefits. If access is to the retail level, it will be restricted to competition over the retail margin which may offer small potential gains based on the superior efficiency of entrants of providing billing, marketing, customer care and after sales services. This may not generate significant benefits to consumers in the form of greater price competition. These gains may also be offset by other remedies which accompany mandated access. For example, the CD states it would be rare for Oftel to mandate access without imposing a non-discrimination condition. However, a non-discrimination rule can generate offsetting costs by reducing the willingness and ability of operators to develop innovative wholesale deals with service providers and others;²⁰ deterring price competition (as the EC Commission has suggested may be the case for international roaming);²¹ creating allocative distortions by preventing fixed cost recovery using Ramsey pricing methods, and reducing the network operators' flexibility to provide greater choice to service providers and retail customers.²²

Error costs

This brings us to the second important consideration which is generally underplayed in the discussion of regulation, but is most pronounced in the regulation of innovative markets – regulatory error.

Most discussions assume that the NRA will have relatively good information on the benefit, costs, and each remedy's effectiveness. In practice there is considerable uncertainty both about the nature of effective competition in network industries, and the impact of regulation on investment and competition. Thus a concomitant of *ex ante* regulation is that the benefits of regulation come at a cost due to regulatory errors.

Regulatory errors can be of two general types – when the remedy is wrongly imposed (Type I errors); or the failure to impose a remedy when justified (Type II errors). These errors might arise because the rules are imperfectly matched to the market power abuse, either by faulty design or because the regulator lacks sufficient information to

²⁰ This is recognised by Oftel elsewhere: *"There is evidence that commercial strategies of the mobile operators, rather than regulation, are the factor that determines how many ISPs develop a successful relationship with a network operator. Oftel believes that the current regulation may have unduly focused service providers and network operators on the single business model that has grown up around the regulated obligation to supply. It also may be the case that the willingness of operators to develop innovative wholesale deals is being deterred by the prohibition on undue discrimination."* Oftel, *Effective Competition Review: Mobile* (26 September 2001), para 2.47.

²¹ EC Commission, *Working Document on the Initial Findings of the Sector Inquiry into Mobile Roaming Charges* (13 December 2000). Wolf Sauter (DG COMP) commenting on the preliminary findings states: "Wholesale roaming markets are oligopolistic markets that appear to lack competitive pressure. They are characterised by high barriers to entry due to national licensing and spectrum limitations; due to high network infrastructure costs; and due to first mover advantages that appear to work against DCS 1800 licensees [...] In addition, there appear to be a general lack of incentives to compete, due to the almost perfect price transparency between operators at the wholesale level and a near complete absence of price transparency for consumers at retail level. [...] Industry-wide non-discrimination obligations reduce competitive pressure..."

²² McAvoy study of the FCC decision, under pressure from AT&T's rivals, the prevent AT&T from reacting to competitive entry by discounting tariffs and sharply lowering prices, found that the prices for long distance services had decreased significantly less than costs of providing services. P. MacAvoy, *The Failure of Anti-trust and Regulation in Longdistance Telephone Services*, (MIT Press 1996) 105-174.

apply the appropriate remedy. It may also be the case that the remedy is designed in a way which makes one type of error fairly certain.

Further, and important for the discussion here, is that the “costs” of regulatory errors are asymmetrical. Generally, or as a generalisation, the costs of a Type I Error is larger than that of a Type II error. A Type II error, failing to impose regulation when it is efficient to do so, will result in a dead weight loss which is less than the redistributive effect from higher price that a SMP operator will be able to charge. However, if the regulator commits a Type II error by setting the regulated price below the “competitive” price for some products or service that depresses the rate of return below the “break-even” point then the SMP operators will cease to offer the service. Thus a Type II error results in the loss of the entire consumers’ (and producers’) surplus. Therefore, an efficient regulatory system should guard against Type I errors more than Type II. Unfortunately, the bias is often the other way around - Type I errors are ignored while the danger of Type II is seen as more significant and to be pursued.²³ The result is an inherent bias to over-regulation, as opposed to application of the principle of forbearance.

Implications

These two related factors – over-inclusion and regulatory errors – need to be made more central to the way the AID is to be implemented. They point to the real prospect of over-regulation of the sector, and the way *ex ante* regulatory obligations will differ from the application of competition rules. As stated above the greater emphasis placed on economic efficiency considerations in the determination of *ex ante* regulation reflects the longer-term nature and increased burden that such regulation imposes on the communications sector.

In general, these considerations point to the need for “safety valves” in the form of clearly stated defences and a higher burden of proof when imposing *ex ante* regulation, and which rise with the harshness of the contemplated remedy. This is especially so when it is appreciated that SMP operators are subject to the general rules of competition law which deal with all the abuses covered by the FD/AID, and which is also enforced by OfTel.

²³ The Australian Productivity Commission in a recent assessment of the access regime under Australian competition law, that: “A striking premise underlying the TSLRIC is that it presupposes that the regulator knows how to run an efficient network, and may know this even better than the incumbent. This premise is suspect – and the risk of regulatory error is high. NERA’s (1999) modelling of TSLRIC costs associated with the PSTN have relatively wide bands of uncertainty. This uncertainty over efficient costs needs to be accommodated in access pricing determinations. (...) Thus, it would be fallacious to conclude that uncertainty was resolved from the fact that recently published estimates no longer include a range (table D.1). The factors that led to these uncertainties remain unresolved. Indeed, taking the three sources of uncertainty together (call conveyancing costs, line costs and the allocation method for the access deficit) it is plausible that the band of uncertainty around the midpoint estimate of PSTN is approximately plus or minus 30 per cent. (...) As shown above, the cost estimates underlying the TSLRIC are imprecise, so that regulatory error is inevitable. Even if over successive judgements, the regulator generates unbiased estimates of the TSLRIC price, the regulator will sometimes set prices that are too high and sometimes too low. However, the impacts of downward errors may be different to that of upward errors, requiring that the regulator adjust the price to take account of the adverse effect of errors”. Australian Productivity Commission, *Telecommunications Competition Regulation, Inquiry Report*, (December 2001) 627-630.

Second, and also of general applicability, is that the existence of regulatory error must be expressly taken into account both in the substantive and remedial parts of *ex ante* regulation. As discussed above, the consequences of Type I and Type II errors are asymmetrical, and the optimal regulatory framework must place a greater weighting on the avoidance of Type I errors. This, again, is more pronounced for *ex ante* regulation because unlike *ex post* regulation it does not deal with specific market abuses but sets out general rules which must be adhered to by SMP operators. This is why the Australian Productivity Commission in its recent extensive review of access rules under the Australian *Trade Practices Act* concluded that “... *the inefficiency arising from regulatory error may outweigh inefficiencies resulting from unregulated market outcomes, and therefore often justifies no action.*”²⁴

Finally, these considerations – over-inclusion, efficiency and regulatory errors – are most pronounced for innovative markets where future market developments are by definition unknowable and at best highly speculative. It is in this area that one of the underpinning principle of the proposed EC regulatory package is most relevant – i.e. forbearance. The NRA must desist from intervention unless there are appreciable expected benefits, and where the benefits of intervention are speculative and subject to wide margins of error.

MARKET DEFINITION

We have another general concern about the CD’s proposed approach to market definition in general, and especially the attempt to apply this to innovative markets. The discussion in the CD (and indeed the EC Commission’s *Recommendation*) reflects a subtle, but important, shift in the emphasis over market definition with potentially serious implications. This is the shift from distinguishing between infrastructure/facilities (so-called “access markets”) and services, to that of wholesale and retail markets. We do not agree that access can be viewed simply as a wholesale market issue as proposed in the CD. Rather the assessment of competitive constraints at the downstream level is the appropriate starting point in general, and if there a serious anticompetitive concerns for assessing innovative products.

The CD sees access as an issue of “wholesale regulation”. The CD defines access as “... *any wholesale service which enables competitors to deliver their own services to customers.*”²⁵ This is not the appropriate characterisation of the access issue. The AID offers a more restrictive interpretation of access as related to facilities and infrastructure in line with the *Access Notice*. However, the issues posed by access are more complex and structural than indicated by assuming a wholesale market as the starting point. In many cases there is simply no wholesale market as such in which non-network operators can buy network elements required to supply a retail service.

This concern is reinforced by the EC Commission’s decisional practice in the communications sector under the EC Merger Regulation. This does not routinely draw a distinction between wholesale and retail markets. For example, the EC Commission has

²⁴ Australian Productivity Commission *Telecommunications Competition Regulation: Draft Report* (2001).

²⁵ CD para 1.10.

examined well over 50 mergers/concentrations in the mobile sector in the last seven or so years applying the same principles of market definition and market power as will be required under the AID, and in not one has the wholesale market for call termination on mobiles (or any other) been identified as a separate relevant product market. Indeed, in *Telia/Telenor*,²⁶ the first attempted merger between two incumbent and geographically contiguous fixed and mobile operators with extensive interests in each other countries, the matter was discussed and rejected by the Commission. This despite the fact that the Commission's remedies were highly interventionist (and regulatory) in requiring Telia to divest its cable network and agree to Local Loop Unbundling. The implication of this silence in competition law is that when applied in case-by-case analysis of prospective market power problems in the communications sector it has not occurred to the Commission to define a wholesale market. This is because it is not self-evident when a number of networks compete directly, that there necessarily will be a wholesale market in the sense used in the CD. The interconnection arrangements between the network operators are not a wholesale market as such, but the sale of access to ensure end-to-end connectivity.

The general presumption that access can be treated as a wholesale market issue and by an assessment of SMP in that market is incorrect. In all cases where access is requested, the issue must be assessed initially at the retail level to establish that access is necessary for sustainable effective competition. This is not clearly emphasised in the CD, and will lead to attempts to see access as a right on showing that a downstream rival cannot compete unless it can use the SMP operators "upstream/wholesale" inputs.

That evaluation of access at the retail level is paramount is clearly stated in the AID and competition law. Article 12(1) of the AID states that even where a network operator has SMP access is only available if in addition the NRA:

*"... considers that denial of access or unreasonable terms and conditions having a similar effect would hinder the emergence of a sustainable competitive market at the retail level, or would not be in the end user's interests"*²⁷

Oscar Bronner²⁸ makes the position even clearer.²⁹ The Advocate General's ("AG") opinion in particular states that it is not the competitive position of the facility owner but

²⁶ In *Telia/Telenor* (Case COMP/M.1439 (1997)) the Commission concluded that origination and termination were one (bundled) product market for the purposes of the application of EC competition rules. Since that case was the first ever merger between dominant incumbent fixed operators who were also dominant in the provision of mobile services (and network infrastructure) the issues were rigorously analysed in contrast to the many Phase I (and regulatory) decisions cited in the SO. In *Telia/Telenor* the Commission noted in relation to fixed sector, that the end consumer buys and treats a telephone service, as does the SO, as "a bundled product for both call termination and call origination" (SO para 86). It noted that it would be difficult for the subscriber to disentangle the various prices of the elements or "unbundle" in and outbound calls by purchasing the services from different operators. It concluded, "Accordingly, the relevant markets are taken ... as comprising incoming and outgoing calls". (*Telia/Telenor*, para 87).

²⁷ This is reiterated in the Commission's draft *Recommendation* on pre-defined markets: "The starting point for the definition and identification of markets is a characterisation of retail markets over a given time horizon, taking into account the demand side and supply-side substitutability. Having characterised and defined retail markets, it is then appropriate to identify relevant wholesale markets." *Working Document on Relevant Product and Service Markets within the electronic communications sector*. (June 2002). Note we would disagree with the Recommendation's view that this necessarily leads to the delineation of a wholesale market as such.

that in the downstream services market that is critical. As the AG states the goal of competition law is not to protect competitors but competition, and that competition is not an end in itself, but the means to enhancing consumer's welfare:

"58. "Thirdly, in assessing this issue it is important not to lose sight of the fact that the primary purpose of Article 86 [now 82] is to prevent distortion of competition - and in particular to safeguard the interests of consumers - rather than to protect the position of particular competitors. It may therefore, for example, be unsatisfactory, in a case in which a competitor demands access to a raw material in order to be able to compete with the dominant undertaking on a downstream market in a final product, to focus solely on the latter's market power on the upstream market and conclude that its conduct in reserving to itself the downstream market is automatically an abuse. Such conduct will not have an adverse impact on consumers unless the dominant undertaking's final product is sufficiently insulated from competition to give it market power.

It may be noted that in Commercial Solvents Advocate General Warner, in coming to the same result as the Court, also considered the position on the downstream market:

²⁸ Case D-7/97, *Oscar Bronner GmbH & Co. KG v. Mediaprint Zeitungs-und Zietschriftenverlag GmbH & Co. KG and Others*; and Opinion of Advocate General Jacobs delivered on 28 May 1998, European Court Reports 1998 page I-7791. (hereinafter AG's *Opinion*)

²⁹ In the *SMP Guidelines* the EC Commission has sought to distance itself from the essential facilities doctrine stating "[A]s regards the "notion of essential facilities", there is for the moment no jurisprudence in relation to the electronics communications sector" continuing "... this notion, which is mainly relevant to the existence of an abuse of a dominant position under Article 82 of the EC Treaty, is less relevant with regard to ex ante assessment of SMP within the meaning of Article 14 of the Framework directive" (*SMP Guidelines*, para 73). This "rationalisation" is unconvincing for several reasons. First, the Commission must ignore the existence of the *Access Notice* which sets out EC Commission's view on how refusal to supply in the communications sector infringes Article 82 (*Notice on the application of competition rules to access agreements in the telecommunications sector – Framework, Relevant Markets and Principles*, OJ C265, 22 August 1998). The *Access Notice* is clear: "In telecommunications sector, the concept of essential facilities will in many cases be of direct relevance to determining the duties of dominant TOs [Telecommunications Operators]". Secondly, EC Commission officials have made clear the applicability of the essential facility doctrine to the communications sector: "The concept of essential facility is a contentious one under Community law, although it now seems clear that it is a principle of general application" (J. Faull & A Nikpay *The EC Law of Competition* (Oxford University Press, 1999) para 11.225 - note the section co-author is Kevin Coates who drafted the *Access Notice*. Also see K. Coates, "Commission Notice on the Application of the Competition Rules to Access Agreements in the Telecommunications Sector", *Competition Policy Newsletter*, 1998/2; H. Ungerer "Ensuring Efficient Access to Bottleneck Network Facilities: The Case of Telecommunications in the European Union" Competition Seminar, Florence Nov 1998 <<http://eropa.ue.int/comm/dg04/speech/eight/en/sp98056>>.). Thirdly, if the doctrine exists under Article 82, it potentially exists under the application of the *Framework Directive* and *SMP Guidelines* which seeks to make Article 82 jurisprudence part of SMP. Fourthly, as regards innovative markets, the *SMP Guidelines* note that even on its interpretation, essential facilities is applicable to refusal to supply access to third parties designed to limit the emergence of new markets and products (thus covering innovative markets). Finally, an essential facility is a matter of market definition. As Faull & Nikpay (para. 11.232) state: "Although the concept of an essential facility is raised in Commission practice under the analysis of abuse, it could easily be regarded as essentially a market definition issue. The essential nature derives from the absence of demand or supply side substitutability. Where this essential facility is controlled by a single entity, or, in cases of joint dominance, by two or more jointly dominant entities, competition issues may arise." To the extent that the Commission maintains that termination on each network is a separate market, it is in effect arguing *inter alia* that it is an essential facility.

'I do not think that the question whether the market for the raw materials for the production of a particular compound is a relevant market can, logically, be divorced from the question whether the market for that compound is a relevant one. The consumer, after all, is interested only in the end product, and it is detriment to the consumer, whether direct or indirect, with which Article 86 is concerned.' (para 266).³⁰

ACCESS TO INNOVATIVE PRODUCTS

The CD's inclusion of and approach to *"innovative products"* is of particular concern. The CD, while noting the adverse impact that access can have on the incentives to innovate and invest, treats access to innovation as largely a distributive issue. The CD rejects the claim that the SMP operator should be the sole exploiter of its innovations. The result is a mandatory access rule which is more onerous than the regulatory requirements for SMP in mature markets, making concessions to any adverse impact on future innovation by vague a reference to *"generous price"* and more sensibly to the application of retail minus access pricing.

CD's Proposals

The basis for the CD's apparent mandatory access rule in innovative markets is theoretically based on the concept of *"leveraged market power"* under Article 14(3) AID. In theory, a vertically integrated operator who has developed a new product has an incentive to leverage its upstream market power downstream by denying access to or imposing onerous access terms which disadvantage its downstream rivals in a way that has an adverse effect on effective competition. Alternatively, and less clearly, the CD may have in mind that each innovative product be defined as a separate relevant product market and that access be mandated if the operators are found to have SMP on that market.

The solution that the CD proposes is mandatory access. This is based on another theoretical observation. The CD argues that in theory a vertically integrated network operator would be indifferent between self-provision and third party provision of innovative product provided the terms of access were *"sufficiently generous"*,³¹ that in practice mandating access is acceptable. The CD proposes that a SMP operator should not be able to refuse a *"reasonable request for access to be the sole exploiter"* and *"be required to supply an equivalent wholesale product when introducing innovative retail services"*. The CD states that where a SMP operator launches a new retail product it will need to make access available to any underlying wholesale services *"in sufficient time for simultaneous launch by competitors of a competing retail product so as to avoid a material effect on competition."*³²

³⁰ AG's Opinion para 58 & 59

³¹ *"Given sufficiently generous terms ... a vertically integrated operator should be indifferent between selling the retail product itself or selling the underlying wholesale product to another retailer"* CD para 2.23.

³² CD para. 3.12.

The CD correctly proposes that where the product is new and untested, and demand uncertain, the access seeker can be asked to bear some of the development costs, and that there should be a general preference for access prices set using retail minus. Thus the CD seeks to soften the harshness of mandatory access to new products by cost sharing on the one hand and reward sharing on the other, the later recognising that the SMP operator is entitled to a generous return.

Assessment

We have already noted above that the emphasis and proposals given in the CD appear contrary to the express statements in the FD/AID regarding the scope of *ex ante* regulation of the communications sector. There are further concerns about the CD's proposals, namely:

1. The discussion of access to retail and wholesale innovative “products” is confused and unclear. It is not apparent, for example, how markets are to be defined for innovative “products”, what triggers SMP in the innovative product market (SMP generally for upstream inputs, or market power on the market for the product itself), and so on. In short, key aspects of market definition and SMP are simply missing from the CD's discussion;
2. The way leveraging market power is supposed to be assessed (theoretical possibility or real likelihood), and what will determine whether it hinders effective competition (impact on retail market or on wholesale market) are unexplained;
3. Where a proposal for mandated access is based on “leveraged” market power there would need to be substantial evidence based on detailed prospective market study and as under competition law that this ground be used only in exceptional circumstances. So far, the CD only provides a theoretical presumption to justify access to innovative products;
4. The CD claims that because in theory an innovator would be indifferent between exploiting an innovation, or charging a “*sufficiently generous*” access price and having others exploit the innovation downstream, that access will not have adverse effects and is justified. This analysis is based on a static theoretical model which takes no account of the impact on innovation and the complexity of exploiting such innovations, and economies of scope and scale;
5. The requirement that a SMP operator will, when introducing an innovative product, make the “wholesale” components available so that third parties can simultaneously launch their retail version (if that is possible) is not spelt out in any detail. The proposal that all innovations of an SMP operator should be automatically made available to others is a fairly radical proposal which requires more support and evidence of its consumer welfare-enhancing impact than a theoretical observation. This is especially so when it is appreciated that this amounts to a significant interference with freedom of contract and the potential expropriation of the SMP operators' legitimate intellectual property rights/patents;

6. The CD's analysis of innovative products does not appear based on the LTABE test. It gives the impression/presumption that access should not be denied to rivals based on a distributive notion of benefit-sharing (offset by cost/risk sharing) in order to promote downstream competition. However, recall that the test is not whether access fosters downstream competition *per se*, but its impact on consumer welfare. If appreciable net consumer benefits cannot be established, then the fact that the SMP operator is for a period the exclusive provider is irrelevant. To repeat, the test is whether end-users benefit, not whether the innovation can be equally exploited by others; and
7. The CD favours access to wholesale innovative products at retail minus because it is allegedly neutral on SMP operators (including its incentives to invest and innovate). Mandating access to innovative products launched by SMP operators at retail minus introduces competition in the provision of retailing costs, which usually coincides with marketing and billing.³³ This is unlikely to provide great consumer benefits especially in the light of economies of scope that SMP operators are likely to enjoy because of the wider range of retail products they provide. Furthermore, increased choice is scarcely a major factor increasing consumers' welfare when competition is restricted to marketing and billing.

THE ACCESS TEST

We are concerned with the confused discussion of the access test in the CD especially the relationship between LTABE and the notion of a "*reasonable request*".

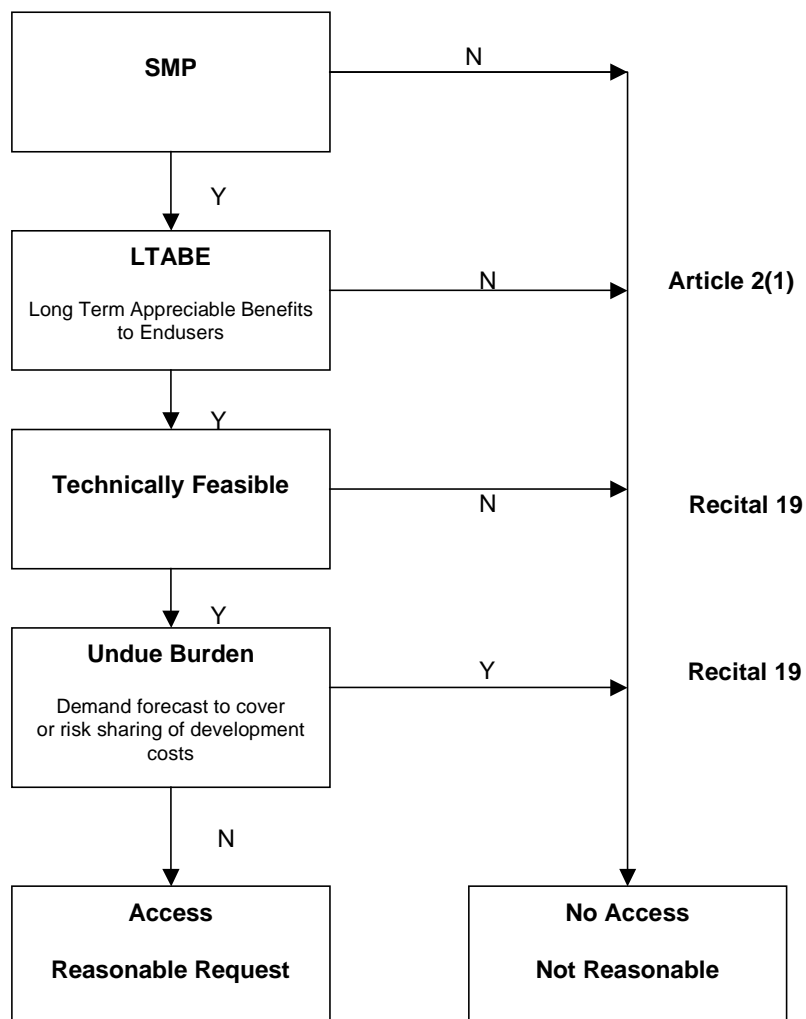
CD's Proposals

Our understanding of the CD's proposals, especially as they relates to innovative markets is as follows. First, the operator or undertaking will have to be found to have SMP on the relevant product/service market. Second, access will be mandated if it satisfies the LTABE test set out by Oftel based on Article 12(1) AID. The SMP operator would then be obliged to meet all "*reasonable requests*" ("RR") subject to the "defences" raised in Recital 19 AID - that access is not technically feasible, and/or that the request requires the operator to provide something which it cannot. The CD further adds a requirement that the access must not impose "*undue burden*" on the SMP operator.

Exhibit 1 below depicts our interpretation of these terms as discussed in the CD. As indicated we see the reasonable request terms set out in the CD as apparent additional elements after LTABE has been assessed (although an alternative interpretation is that they are component parts of LTABE).

³³ For example the CD at Para A5.12 states "*Oftel does not believe that any competing operator purchasing the innovative wholesale product should be charged for activities, such as marketing, which it has to undertake for itself*".

Exhibit 1



Assessment

There is considerable ambiguity and lack of specificity in the discussion of the access test and key terms. Specifically:

1. The relationship between LTABE on the one hand, and a “reasonable request” and “undue burden” on the other, is confused and ambiguous. The discussion in parts of the CD indicates that the concept of a “reasonable request” is a substantive test relating to whether to mandate access i.e. synonymous with LTABE. However, at paras 2.16-2.18 of the CD it appears to relate more narrowly to whether access is technically feasible and can be delivered by the SMP operator. At para 2.19 the concept of reasonableness refers to a

- profit/return constraint which would limit access for innovative products conditional on the access seeker agreeing to accept some risk/cost sharing. Here the term “*undue burden*” is used to not impose on SMP operators’ investments for which they do not receive a “reasonable return”;
2. The discussion is incomplete. The CD does not set out the way the OAE is to be conducted under Article 8 FD and Article 12 AID. This will be the subject of later consultations regarding the OAE guidelines. However, this is critical aspect of the LTABE test, and the definition of “*reasonableness*” as proposed in the CD (para 2.8). In the absence of guidelines on the OAE, it is impossible to assess the CD’s proposals, and in particular to provide a considered answer to Q1 of the CD; and
 3. The CD gives the impression that the request must be reasonable as between the parties. However, the AID requires that the request lead to an appreciable increase in consumer benefits. In many cases access may not generate appreciable consumer/end-user benefits - it may lead to market sharing without any material impact on prices/choice (so-called “business stealing” or more pejoratively “free-riding”)³⁴ thus, artificially increasing the number of operators often only gives the impression of more choice.³⁵

There is a need for more coherence and a greater detail in this part of the CD’s proposals. As we read the AID, and Oftel’s intention, an SMP operator is only required to grant access if the NRA establishes that this would pass the LTABE test. All the other concepts are constituent parts of the LTABE test which will be evaluated through the proposed OAE.

RECOMMENDATIONS

The CD has significantly raised the stakes by proposing that “innovative products” introduced by a SMP operator should be subject to mandatory access obligations. This proposal cannot stand, and is counter to the FD/AID. This is not to say that the opposite is true - that where an SMP operator introduces a new product that it should always have the latitude to establish a first mover advantage which eventually could become unassailable. Rather this possibility is something which must be evaluated case-by-case basis under competition rules, not a template obligation.

Thus, in relation to emerging markets and innovative products we recommend the following:

³⁴ Some regulators concluded that the incremental impact of mandatory access was *de minimis* and did not justify intervention given that network competition could deliver satisfactory outcomes. For example, the ACCC concluded that mandating access to mobile network for long distance services was unnecessary (ACCC, *Competition for long distance mobile telecommunications services*, January 2000). The Italian AGCOM declined to mandate MVNOs because of the marginal impact in the light of increasing competition and the risks due to reduced investment incentives (AGCOM, *Condizioni Regolamentari Relative all’ingresso di Nuovi Operatori nel Mercato dei Sistemi Radiomobili*, Delibera 544/00/CONS).

³⁵ P. MacAvoy, *The Failure of Anti-trust and Regulation in Longdistance Telephone Services*, (MIT Press 1996) 105-174.

Reasonable Requests

1. Long Term Appreciable Benefits to Enduser (“LTABE”) is accepted as the overriding test for mandating access;
2. Access, or a specific remedy, should only be imposed if it leads a) to appreciable consumer benefits in the form of price competition and choice; and b) does not generate offsetting costs in the form of the likelihood of reduced investment and innovation;
3. Oftel urgently needs to clarify the relationship between LTABE and its proposals on “*reasonable requests*” and “*undue burden*”;
4. Oftel’s proposal that access can be assessed or viewed as a “*wholesale market*” issue is incorrect. Market definition and access must be assessed initially at the retail level to determine whether access will generate appreciable benefits to consumers;
5. Oftel should set out a clear statement on the burden of proof and evidentiary standards it will adopt when mandating access. Given that access is intrusive regulation, expropriates private property rights, and imposes a high regulatory burden, the burden of proof must be set at a high level and be satisfied by Oftel;

Forbearance/Burden of Proof

6. Oftel should clearly state that forbearance is a key element of its enforcement procedures, and in particular it should set out its position on the asymmetric impact of Type I and Type II errors. We propose that all regulatory intervention be based on the avoidance of Type I errors, or that these be given a higher weighting than Type II errors;
7. Innovative product markets should be dealt by Oftel using its powers under the *Competition Act 1998*. They should not form part of the guidelines under the AID;
8. Clear guidelines should be set out for market definition in innovative markets;
9. Oftel should spell out how it intends to apply leveraging analysis under Article 14(3) AID for innovative products;
10. Oftel should state that designating an operators as having SMP on a specific market on the basis of leveraged market power will be an exceptional finding;

Options Appraisal Exercise (OAE)

11. Oftel should not make a final decision over the implementation of AID until the EC Commission has completed its consultations and finalised the *SMP Guidelines*, the *Recommendation*, and any remedies guidelines, and Oftel has drafted its OAE guidelines;
12. In the absence of Oftel's draft of the OAE guidelines we have not be able to assess Oftel's proposals; and
13. Oftel's OAE should contain sensitivity projections which incorporate statements as to benefits, costs, and especially error costs of each proposed remedy.