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Making market definition work: the case of telecoms (de)regulation

Under the European regulatory framework governing electronic communications established in July 2003 national regulatory authorities (NRAs) can impose regulatory obligations on telecoms operators *'only where the [relevant] markets are considered not to be effectively competitive as a result of such undertakings being in a position [of significant market power (SMP)] equivalent to dominance within the meaning of Article 82 of the EC Treaty'*.[1] In other words, the hurdles that must be cleared before regulatory intervention can occur are defined explicitly to meet general competition law standards.

Just as the dominance criterion can provide an important safeguard against unwarranted interventions by authorities who 'know abuse when they see it' in Article 82 cases, the value of this regulatory constraint arises where it prevents NRAs from intervening when they would otherwise be tempted to do so. However, market definition must be conducted in a rigorous and objective manner for this safeguard to be effective. It must not be viewed merely as an inconvenient requirement to 'tick boxes'.

The European Commission is currently reviewing the e-communications regulatory framework. As part of this review, it has issued draft proposals for revised recommendations on relevant product and service markets.[2] This provides a timely opportunity to assess the approach adopted. In this Brief, we consider two particular issues, illustrated by developments in the broadband arena. The first concerns relevant product market definition at the wholesale level when different technologies, utilised by different intermediaries, provide competing services to end-users. The second example concerns the evaluation of relevant geographic markets.

Different technologies = separate markets?

A variety of technologies and organisational structures may be deployed to deliver telecoms services which end users would regard as substitutes. Indeed, one of the key dynamic features of telecoms competition is the growing variety of alternative service provision models that exist. This is notably true of broadband, where loop-based DSL, cable modem, and fixed wireless are all examples of technologically distinct ways of delivering services whose ultimate features are comparable in many important respects. Moreover, in the case of DSL, for example, a number of alternatives ways of organising who provides what in the supply chain are observed too.

However, it is the strength and source of competitive constraints that should determine market boundaries and not technological or organisational characteristics per se. Importantly, products displaying some quite different technical characteristics may be close substitutes, while in other cases products showing some superficial similarities may not provide meaningful alternatives. The standard market definition test under competition law (the SSNIP test) provides a framework for sifting the relevant from the irrelevant in this regard.

In its draft proposals with regard to local loops, the European Commission nevertheless appears intent on continuing to advocate an approach to market definition which focuses narrowly on the technological options available to a specific set of wholesale customers.[3] In justifying a distinct market for wholesale unbundled access to metallic loops, for instance, the Commission highlights that *'an operator using unbundled local loops will not normally consider wholesale broadband access service to be a substitute even if the service provided by the broadband service provider allowed the supply of all the same services that were provided over the unbundled loops'*.[4] This

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Commission guidelines on market analysis and the assessment of significant market power under the Community regulatory framework for electronic communications networks and services (2002/C165/03), paragraph 5.

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See European Commission Staff Working Document: Public Consultation on a Draft Commission Recommendation on Relevant Product and Service Markets, June 2006.

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Commission objections to conflicting NRA decisions in this context have been muted to date, since differences in market definition have not actually influenced SMP decisions at the loop level.

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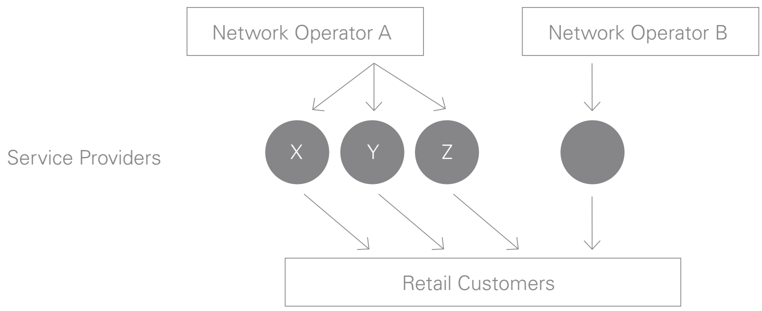
See page 24 of the Explanatory Memorandum to Commission Recommendation on relevant product and service markets, and page 29 of the Commission's Draft Recommendation of June 2006.

approach fails to recognise that a broad market definition may be appropriate even if this characterisation of choice is correct.

Where a customer relies on technology-specific investment, this may well preclude direct demand-side substitution to a technologically distinct alternative. Technology barriers may also constrain the scope for effective supply-side responses. However, these limitations need not imply, as the SSNIP test requires, that a monopoly wholesale supplier of products utilising a particular technology would necessarily be able to raise prices significantly above competitive levels. Instead, the scope for indirect substitution may have a decisive impact, as recognised by a number of national regulatory authorities in their broadband market definitions.[5]

Consider the example illustrated in the figure below. Network Operator A provides services to wholesale customers X, Y and Z.[6] In turn, these retail service providers supply final consumers. Network Operator B delivers services to the same end user market via an entirely vertically integrated, technologically distinct route.

Figure 1: Infrastructure Competition



Even though the stand-alone retailers in our example – X, Y, and Z – have no alternative but to purchase wholesale services from Network Operator A, making A the sole supplier of such services, this does not imply that these services constitute a distinct relevant wholesale market for competition purposes. If (i) a standalone retailer faced with a significant increase in wholesale charges would largely pass through such increases in its retail prices, and (ii) competition between the stand alone retailers and Network Operator B was sufficiently vigorous at the *retail* level for such pass-through to result in a substantial contraction in sales, then the profitability to A of its original wholesale price increases would be undermined. In other words, the hypothesised narrow market for *wholesale* supply of services to X, Y and Z may fail the SSNIP test. It does so because of the effective constraint provided via the *retail* level by the services delivered over Operator B's network.

There are some signs of movement in this respect in the Commission's stance on 'bitstream' access. In reaction to a number of NRA decisions, it is now apparently prepared to accept that an indirect constraint may be taken into account in assessing SMP, though it seems unwilling yet to concede the relevance for market definition. While this issue of whether analysis is conducted at the market definition or competitive assessment stages is of secondary importance in principle, provided that analysis is rigorous and robust, this has not always been the case in practice.

Significantly, the implications of our example also apply to situations where alternative vertically-related access arrangements provide entrants with different means of offering substitute services to end users. For example, if access to unbundled local loops enables effective competitive entry, then this might be expected to constrain the pricing of bitstream access too. More importantly, the impact of LLU-based entry on retail competition may render the competitive contribution of the bitstream access alternative irrelevant.

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See, for example, UK regulator Ofcom's Review of the Wholesale Local Access Market: Explanatory statement and notification of December 2004. Ultimately this is an empirical issue. The indirect mechanism was also considered by the Dutch regulator, OPTA, in assessing local loops, for example, but was rejected on empirical grounds.

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This might include self-supply of its own retail operations.

Thus, even supposing a well-defined, narrow wholesale market could be sustained and that this was served by a monopoly supplier, such as Network Operator A in our example, this is still consistent with there being effective competition at the retail level. It is far from obvious that regulatory intervention to support entry at a specific wholesale level would be justified in this case, so long as consumer interests were protected by vigorous rivalry at the retail level, driven by effective infrastructure competition, for example. Robust competition policy should be aimed at addressing welfare-affecting competition failures and not the predicaments of particular competitors. Moreover, longer-term considerations favour a regime designed to encourage the development of rival infrastructure where this is feasible.

Local loops = local markets?

Geographic market definition matters for the analysis of competition in telecoms access services because the rivalry faced by incumbent operators frequently varies significantly from one location to another. Where the provision of services requires fixed investment in local infrastructure, new entrants are naturally most likely to emerge where their prospects are brightest – generally in areas of relatively high customer density, and where demand for new and differentiated services (such as high-speed internet or video on demand) is likely to be strongest.

The provision of the 'last mile' of physical access to individual premises is perhaps the most inherently local of all telecoms services. As such, the supply of these services would seem to be among the strongest candidates for narrow geographic market definition.

It is plain to see that overly broad geographic markets can lead to misleading SMP findings. Specifically, a national carrier's share of a national geographic market will overstate its market power in locations where competition is established, and understate it in areas where such competition is absent. In the UK, for example, entry by the cable-TV companies has been focused on urban areas, with their local networks passing around 50% of all households in total. An emphasis on national shares alone would obscure this essential competitive reality.[7]

Nevertheless, this aspect of market definition has received relatively little detailed attention in the SMP assessment process to date. Discussion of geographic market definition in the Commission's guidelines, for instance, is limited, focusing on the fact that this has 'traditionally been determined' with respect to (i) the area covered by a network, and (ii) the existence of legal and other regulatory instruments.[8]

The SSNIP test approach to market definition allows us to improve on this. Applying this framework to the basic attributes of the demand for and supply of fixed telecoms access to individual premises provides a strong case for local market definition. Demand side substitution would effectively require a change of address on the part of the final user, and the feasibility of supply-side substitution, through network operators located outside the area concerned extending their service networks, is likely to be confined to a relatively limited perimeter fringe at best.[9]

Such considerations matter because narrower geographic market definitions could imply a change in SMP conclusions and a more rapid withdrawal of regulation in some areas. As well as providing greater freedom to incumbents, this would also probably make life harder for some competing intermediaries.[10] However, such selective removal of protection to smaller entrants is in the nature of the transition from regulation to competition.

A market for nationwide service provision?

Some may argue that narrow geographic market definitions will fail to capture the competitive advantages held by incumbent operators with extensive networks even in

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Cable's broadband share in the UK has fallen sharply over time (down from around 50% in mid-2003 to under 30% by Autumn 2005) due to the much faster growth in uptake of DSL-based services over recent years. Interestingly, in clearing the merger of cable operators ntl and Telewest in December 2005, the UK's Office of Fair Trading noted that the lack of geographic overlap in the two cable networks substantially limited any horizontal issues.

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See section 2.2.2 of the Commission's market analysis guidelines.

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Evidence of uniform national pricing does not imply that markets are national, as consideration of the SSNIP test question will confirm. Moreover, it would seem relatively straightforward to implement area-by-area variations in the pricing of fixed local access services by conditioning discounts on customers' home addresses, for instance.

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Depending on the specifics of network architecture and accounting procedures, it could also make implementing residual regulation a more challenging task.

areas where they face local rivalry. However, such apparently geographic considerations may actually point to the need for a more fundamental re-examination of product market definition.

Where customers, are looking to purchase fixed local access services over a broad geographic area, then an operator with an extensive network will be able to offer a 'one-stop-shop' solution that local operators cannot duplicate. To the extent that customers value such integrated service, this might allow a price premium to be charged even where there are local alternatives, pointing to a distinct relevant market for national services: a hypothetical monopoly supplier of a nationwide local access service may be able to raise its prices profitably above competitive levels, unconstrained even by the availability of local offerings which, when combined, are technically equivalent. The Commission apparently reaches similar, if rather confusingly worded, conclusions in suggesting that, quite often, *'individual services in a cluster are not good substitutes for each other yet can be considered to be part of the same relevant market'*.[11]

In practice, the 'one stop shop' advantages held by a national operator may extend across products which would not naturally belong to the same relevant market, even under the circumstances described above. In this case, the competition issue concerns the potential for harmful leverage of market power from one geographic area to another (or from one service to another). Where the established national operator's *national* competitive advantages derive from its control over the only source of network access available in some areas, these advantages therefore seem better analysed at the competitive assessment stage.

In any event, rigorous appraisal of these issues is certainly not best accomplished by artificially aggregating geographic markets simply to spread high average market share numbers for a national operator across a broad territory.

11 Commission Staff Working Document: Public Consultation on a Draft Commission Recommendation on Relevant Product and Service Markets, June 2006, section 3.2.

Conclusions

It is vital that SMP assessment is undertaken as a genuine check on regulatory activity, and not simply with a view to convenience, allowing maximum regulatory discretion or justifying pre-determined interventions. Such assessment provides the basis for developing a thorough understanding of the realities of competition. As such, a consistent and rigorous approach to market definition would make a genuine and substantive contribution to the policy objective of market deregulation.

Where difficult competition issues do arise, to adopt formalistic market definitions based on historic assumptions or technical descriptions or 'average' conditions across Member States is to miss out on the key contribution that the process of market definition and competitive assessment can offer. Done properly, but only if done properly, this process enables the accurate identification of competition problems, facilitating the implementation of targeted and effective remedies.

Crucially, in an industry such as telecoms for which convergence is an on-going source of market dynamics, it also allows us to identify areas where the role for sector-specific regulation has run its course, and where markets should be allowed to develop free from artificial constraints.