

# **COMPETITION POLICY VERSUS SECTOR-SPECIFIC REGULATION IN NETWORK INDUSTRIES – THE EU EXPERIENCE**

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# Competition policy versus sector-specific regulation in network industries – The EU experience

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## ***1. Introduction***

In the past, networks industries were national monopolies. The role of public authorities was to guarantee that prices were acceptable in the eyes of the public opinion, and that the public service obligations were fulfilled. Competition policy issues were completely absent in both these industries. As noted in a study by the Institut d'Economie Industrielle (European Economy, 1999) for the European Commission , "In the previous monopolized environments, the main economic issues were the setting of a proper price structure, the encouragement of cost efficiency, the extraction of monopoly rents and the protection of the company's long term investments against expropriation. Antitrust policy, with its focus on competition, had little to contribute<sup>2</sup>".

The objective of liberalization is to induce competition in prices, creating incentives to lower production cost and increasing product innovation (Nicoletti G. and Scarpetta S., 2003). The E.U. Commission produces regular evaluation report of the performance of network industries providing services of general interest (E.U. Commission, 2004). These reports shows that the legal and regulatory framework designed to allow network industries to operate more efficiently is evolving and that market structure are changing as reforms are progressively implemented. However, despite the positive changes observed, the gap between effective and legal opening up to competition is still significant. That raises the question about whether regulation or competition policy was the best tool to oversee the liberalization of network industries and to what extent competition policy and regulation were complements or substitutes (Crampes C, 2002, Koski Holi and Kretschner T., 2004).

The aims of the paper is first of all to present the pros and cons of antitrust and regulation in network industries, at the intersection of competition law and sector specific regulation. When is competition law sufficient and sector-

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specific legislation necessary? Economists, lawyers with an expertise in network industries hold different views on the necessity of sector-specific regulation. According to some, special characteristics of certain network industries makes necessary to introduce and maintain specific regulatory measures, as for others competition law is sufficient in network industries.

The other objective of the paper is to present a statement of the facts, a description of what has happened in the recent years in the E.U. in the context of regulation and competition in network industries with special emphasis on telecommunication and postal sectors. Telecommunication is interesting since it is an industry that started the gradual movement towards full liberalization and where the importance of competition law and regulatory policy in making this transition has been underscored. At the opposite, the postal sector is lagging behind in term of liberalization. It is also a sector where the natural monopoly was widely considered concerning one segment namely distribution, and where the problem of financing the cost of universal obligation is essential. The paper presents also on some of the most important issues raised here, some of the critical responses of economists concerning the choice of regulation vs. competition in telecommunication.

The remainder of the paper is structured as follows; Section two presents the main differences between competition policy approach and sector specific regulation. Section three shows how the new regulatory framework of telecommunication is grounded on competition law principles and some of the critical responses addressed to the new framework. Section four presents why and how the EU competition law is applicable to undertakings in regulated sectors. Finally, the last section presents situations where competition law is addressed to Member States. It provides an overview on how States' measures can affect the structure of a market and how the resulting structure can lead to a situation in which the undertaking can abuse its position.

## ***2. Differences between sector-specific regulation and competition policy approach***

Liberalization and technological innovations are significantly changing the market structure of regulated industries highlighting the need to redefine the nature of public interventions. One of the central questions is to what extent the removal of certain regulatory interventions such as ex-ante regulation has created less distortions in markets.

To clarify the debate on which institution has to oversee the process of liberalization of network industries, it is useful to stress several differences between competition and regulation:

### **2.1 Ex ante versus ex post approaches :**

The regulatory approach relies on detailed ex ante prescriptive business conduct, for example price controls. In the ex ante intervention, regulatory agencies have to take forward looking view of different business conducts and place restrictions on certain conducts. Thus, enterprises face less uncertainty due to regulation interventions.

The competition approach usually operates ex post and it is basically a harm-based approach. Whilst there are no ex-ante restrictions on business conduct, enterprises face the risk to be penalized if their business conduct is found to be an abuse of dominant position or market power (Decker C. and Yarcobots, 2000).

In network industries, one of the most important issues is the pricing for interconnection among competitors (OECD, 2004). New entrants need interconnection on the network of the incumbent in a number of network industries. In principle, it is easier to ex post judge if a price is unfair than to set ex ante a fair price. However, ex-post aspects of competition policy may create uncertainties for new entrants. They have to make huge investments

without any clear information on the interconnection charge and its future evolution. Ex ante regulation is biased against one set of error (business doing consumer harm) and ex post competition policy is biased toward another set of errors, ensuring business can operate. That raises the issue of the weighting of type one and type two errors.

The IDEI report already mentioned (1999) notes that “traditional stand-alone antitrust enforcement may in most network industries not provide the smooth competitive environment it is supposed to create (...) Designing a proper interconnection policy requires not only: (a) a sophisticated understanding of economic incentives and effects, but also and to a varying degree depending on the regulatory mode, (b) substantial technology expertise and (c) considerable cost and demand information”.

Regulation also imposes costs that can be high and regulators generally lack of economic and technological information needed to make decisions on forward-looking prices.

Moreover, competition policy is not unable to handle foreclosure issues, refusal to deal or price discrimination as it will be discussed later on. However, antitrust investigations, like abuse of dominant position, can take may take several years, which could be a time period too long to bear for new entrants.

## **2.2 Institutional design and human resources:**

Competition authorities have a horizontal approach and are required to intervene and to impose penalties for abuse of dominant position, cartels or mergers in any industry. This implies expertise and decisions on very different market structures and technologies. To accomplish these horizontally differentiated tasks, they are generally divided according to horizontal competencies.

In the large majority of member states, regulatory authorities are specialized by sector, even if there are obvious economies of scale between certain regulated industries in the process of regulation. Moreover, technological progress tends to smooth the traditional boundaries between sectors. For example, gas and electricity are easily interchangeable since gas is used to generate electricity. Telecommunications and postal services are competitors in some markets. These issues become crucial in the process of assessing which is the optimal number of regulators authorities and which industries should be grouped together. Some Member States have already experienced the merge of regulatory bodies for related sectors like Reg TP in Germany which is in charge of telecommunication and postal services or OFCOM in the UK which is in charge of audio visual and telecommunication services.

The horizontal nature of competition authority and the sector specific nature of regulatory authority imply that the two authorities have different qualification of personnel. In the regulatory authorities, greater decisional power lies in the hand of engineers. On the contrary, in the competition authority, greater decisional power lies in the hands of lawyers and, sometimes, economists. Of course, lawyers assist regulators and judges rely on technical experts. The main difference is that for regulation, decisional power lies in the hand of policy makers rather than courts and competition policy has power vested in courts.

The existence of certain conflicts between competition and regulatory authorities are partly explained by the potential divergences between the “horizontal type” of competition authorities and the “vertical” type of regulatory authorities, and by the difference of the decisional power.

### **2.3 The amount and nature of information required:**

The regulatory approach supposes much more information than the one needed under the competition approach. The ex post competition policy

approach has the informational advantage that it requires the authority to assess the business conduct after the alleged abuse and only in light of what is known at the time of the investigation. However, the information requirements may be more similar when examining the question of remedies.

The regulators need to be much better informed *ex ante* and to get general, detailed and updated information of the sector concerned. This may have a huge informational cost and supposes a long term relationship with the industry incumbents which have the disadvantage to facilitate regulatory capture.

In theory, the role of the regulatory authority is to ensure that the network industry will work in the interest of consumers, or in some instances society, which includes the interests of suppliers and competitors. Therefore, the regulatory authority is supposed to control large number of decisions of industry managers and “to know what is good for everyone, and acts in their name and announcing its decision through administrative texts or decrees” (C. Crampes and A. Estache, 2002).

One of the problems due to such situation is the danger that regulators nominated by governments may be affected by industrial policy considerations in favor of national economic or social interests in some countries. In some cases, of course there is nothing wrong with it, i.e. Universal Service Obligations, which has to be defined by policy makers since Universal Service Obligations has to fulfill social goals rather than just efficiency goals. However, generally there are problems related to the traditional criticisms against industrial policy (Damien J. Neven, Lars-Hendrik Röller, 2000).

## **2.4 Structural versus conduct remedies.**

Competition law and regulation differs also in the type of remedies they impose on undertakings. These differences in remedy follow from institutional competencies and human and technical resources. Competition law

remedies are to a large extent addressed to a specific conduct or behavior, and generally competition law remedies are structural remedies that will not require future extensive monitoring on the conduct of the undertaking. On the contrary, Regulatory remedies are very often detailed conduct remedies, for example wholesale and resale detailed pricing levels, conditions mandating the provision of certain services. This distinction between structural and conduct remedies is meaningful and relevant. However, it can also be the case that sector specific regulators may impose structural remedies for example on licensing (OECD, 1999). Moreover in some areas, structural remedies are not just possible for regulators due to Natural Monopolies.

## **2.5 The temporary nature of sector specific regulation**

One of the disagreements on network industry is whether or not sector-specific regulation should be permanent or temporary. As competition becomes more effective, much of the sector specific regulation will be replaced by the application of the general competition rules. Regulation should be kept to the strict minimum since regulation should only be imposed where there are market failures. As soon as it is possible to achieve a competitive market outcome fairly close to the rest of the economy, it would be logical to abolish the sector-specific regulatory bodies and hand over responsibility to the competition body. There are relatively few areas of networks which are naturally monopolistic, since new technologies have lowered economies of scale and rolled back the number of naturally monopolistic areas.

In the long term, there is the prospect that the opening of network industries to competition may discipline firms to be more efficient, limit potential unfair rents and rebalance price structure. This prospect raises the question about the delineation of regulation. However, public interest considerations, mainly related to Universal Service Obligations, the existence of certain market failures will imply that regulatory authorities will remain necessary over an

extended period of time. That is particularly true for certain areas of network industries naturally monopolistic.

Table 1 summarizes the differences between competitive policy approach and sector specific regulation.

Table 1 : Differences between competition policy approach and sector-specific regulation

	<u>Competition policy approach</u>	<u>Sector-specific regulation</u>
General approach	Ex-post, harm based approach	Ex-ante, prescriptive business conduct
Institution design	Horizontal institution Lawyers and economists	Sector-specific institution: sector-specific engineers and economists
Amount and nature of information required	Only information on the allocated abuse	General and detailed information on the sector
Nature of the remedies imposed on undertaking	Structural remedies addressed to specific conduct	Detailed conduct remedies requiring extensive monitoring
Nature of public intervention	Permanent based on general competition policy principles	As competition is more effective, part of sector specific regulation replaced by competition law

The telecom industry is perhaps the best example of an ex-monopoly industry moving towards liberalization. The speed and degree to which it has been liberalized has been much greater relative to other network industries, due to an earlier start and faster technological progress. , The new regulatory framework for electronic communication shows how in practice competition and sector-specific regulation are working together.

**3. *The new regulatory framework of the telecommunication industry***

The new Regulatory framework of the telecommunication industry is based on a certain number of underlying principles on the role of regulation. The regulatory approach within the new framework, is based on competition law principles; the existence of market power and the possibility of abuse of dominant position (Buigues P-A and Rey P., 2004).

The new regulatory framework of the telecommunication industry covers two fundamental issues. First, it identifies the markets to be regulated and, second, it identifies the operators enjoying significant market power (SMP) on which ex ante obligations may be imposed.

### **3.1 Markets to be regulated**

The new approach adopted for the telecommunication industry provides guiding economic principles on relevant products and service markets susceptible to ex ante regulation (Commission recommendation, (11/02/2003)). Under the previous regulatory framework, following the liberalization of the industry in 1998, several areas in the telecommunication industry were subject to ex ante regulation. However, there was a fundamental discrepancy in the definition of these areas. Those were not “markets” based on competition law and practices but markets delineated in the applicable directives. In order to identify markets in accordance with competition law principles, the recommendation of 2003 proposes three criteria before ex-ante regulation is suitable. The first criterion is the presence of high and non-transitory barriers of structural legal or regulatory nature. The second criterion admits only markets with a structure that does not tend towards effective competition within the relevant time horizon. The third criterion states that application of competition law alone would not adequately address market failures concerns.

#### *Static criteria:*

In principle, communications markets require regulation due to the existence of high and non-transitory entry barriers and the existence of natural monopolies issues (structural barriers and legal or regulatory barriers). Structural barriers to entry exist when the technology and the cost structures create asymmetric conditions between incumbents and new entrants, preventing or even impeding market entry. Structural barriers include, for example, substantial economies of scale and high sunk costs. Structural

barriers can exist where the provision of service requires a network element that cannot be technically and economically duplicated. Legal or regulatory barriers are not based on economic conditions but have a direct effect on the conditions of entry, for example, the number of undertakings having access to spectrum.

*Dynamic criteria:*

The existence or likely existence of entry barriers, although a necessary condition, should not be sufficient to justify the imposition of ex ante regulatory obligations. Given the technological innovations in the communications markets, the possibility of overcoming barriers within a relevant time must also be taken into consideration when trying to identify the relevant markets for possible ex ante regulation (dynamic criteria). In particular, entry barriers may also become less relevant where competitive constraints may result from innovations from potential competitors not currently in the market. The recommendation does not identify markets where entry barrier are not expected to persist over a foreseeable future.

*Criteria for adequate competition law remedies:*

The decision to impose ex ante regulatory obligations in certain electronic communications markets should also depend on whether competition law remedies are or are not sufficient to redress market failures and to ensure effective and sustainable competition over a foreseeable time. When intervention needed to redress a market failure is extensive - for example because an assessment of costs based on detailed accounting is required or because frequent intervention is needed - ex ante regulation could constitute an appropriate complement to competition law. Furthermore, 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. This is particularly important in the telecommunication industries and is not always admitted by regulators.

In summary, the decision to impose *ex ante* regulation to a market should be based on an overall assessment of the effectiveness of competition within such a market, taking into consideration not only static but also dynamic criteria. These criteria should be applied cumulatively each of which is necessary but not sufficient. If only one criterion fails, there is no need of *ex ante* regulation.

The Recommendation provides a list of markets to be regulated based on the three criteria presented above. This list of markets to be regulated is not binding and national regulatory authorities (NRAs) may define additional markets to be regulated, outside the list of the Recommendation. However, the NRA needs the Commission's approval before imposing *ex ante* regulatory obligations on the industry. Therefore, the Commission enjoys a "veto power to extend regulations to markets outside the ones listed in the Recommendation, and the NRAs need to present arguments based on the three criteria discussed above.

### **3.2 Undertakings on which *ex ante* obligations may be imposed:**

Under the old regulatory regime applied in the telecommunications field, NRAs imposed *ex ante* obligations on operators with market share in the relevant market exceeding 25%. Under the new framework, NRAs should impose *ex ante* obligations on operators only if the latter are in a dominant position according to the meaning of competition law. In order to clarify and assist NRAs in applying the new definition of SMP, the European Commission has provided the "guidelines on market analysis and the calculation of significant market power" (2002, 165/03). This new definition of SMP will have the effect of raising the existing threshold level above which *ex ante* regulation is needed. Even more important, it will end the existing asymmetric treatment of companies, which in the past under the old framework had SMP

(market share exceeding 25%), and the dominant companies within the meaning of competition law (market share exceeding 40 to 50%).

On all the markets identified by the Commission in its “recommendation on markets to be regulated”, NRAs intervene to impose obligations (remedies) only when these markets are considered not to be effectively competitive. This is defined when the undertakings hold market power (dominance as defined based on antitrust law concept). The guidelines on “market analysis and the assessment of significant market power” specifically address the following issues: market definition, assessment of SMP, and SMP designation. NRAs define the geographical dimension of those products and services identified in the recommendation, carry out a market analysis of the condition of competition in those markets, designate undertakings with SMP in that relevant market and finally impose proportionate ex-ante measures consistent with the term of the regulatory framework. Furthermore, when it is justified by national circumstances, NRAs may also identify other markets, which are not listed in the recommendation. However, as said in the previous section, they have to follow specific procedures (article 7 procedure) that are described in the next section.

### **3.3 Consultation and transparency mechanism – the “veto” power of the Commission**

When NRAs intend to undertake measures, they need to give the other NRAs and the E.U. Commission the opportunity to comment on these draft measures within a reasonable period of time (one month). Such an opportunity is required when a draft measure could affect trade between member states or an NRA:

- aim at defining a relevant market which differs from those defined in the recommendation on relevant market to be regulated ex-ante

- Decide whether or not to designate an undertaking as having, either individually or jointly with others, significant market power.

Reviewing the draft measures, the Commission may within a period of two more months indicate to the NRA that the draft measure would create a barrier to the single market and require the NRA to withdraw the notified draft measure. The decision of the Commission has to be accompanied by a detailed and objective analysis on why the draft measure should not be adopted and specific proposals to amend this draft measure.

The assessment done by NRAs in different member states of SMP operators could diverge, since SMP is defined on the basis of dominance in the sense of competition law (a “position of economic strength affording an undertaking the power to behave to an appreciable extent independently of competitors, customers and ultimately consumers”). Even if the guidelines provide substantial background, it is not obvious that all NRAs will use the same approach to dominance, in particular in cases of collective dominance. The assessment should differ more specifically concerning collective dominance since it is still an issue opened to debates between economists and lawyers.

The “veto” power of the Commission aims to avoid unjustified divergences between member states and, consequently, fragmentation of the internal market. This procedure prevents NRAs from defining an operator as dominant under sector-specific regulations when it is not dominant under competition law. It also obliges them to justify the attempt of regulation of additional markets other than those listed in the Recommendations.

A first veto decision took place in February 2004 (L. di Mauro and A.G. Inotai, 2004). It concerned a draft measure concerning the markets for publicly available international telephones services provided at a fixed location in Finland, taken by the Finnish communication regulatory authority (Ficora).

The Commission's veto decision was based on criticism of the methodology that Ficora applied during its market analyses. In its veto decision, the Commission encouraged Ficora to undertake, in accordance with the guidelines on market analysis, a thorough and complete analysis of the economic characteristics of the relevant markets before coming to the conclusion of the existence of significant market power.

### **3.4 Remedies imposed on dominant undertakings (SMP)**

Under the new regulatory framework, once an operator is designated as having SMP, the NRAs shall impose appropriate remedies on the basis of the relevant obligations listed in the directives. Once NRAs have decided the appropriate remedy to be imposed on operators, the only recourse available to operators against this remedy is through the national courts. There is no veto power of the Commission on remedies imposed on SMP by NRAs and there is a risk that the remedies imposed on dominant undertakings (SMP) are not applied consistently across the E.U., with the result that there will be regulatory fragmentation on the remedies imposed by the NRAs. However, the Commission may intervene when NRAs impose on SMP operators obligations other than those listed in the Access Directive.

The Directive laid down a range of remedies to be imposed on undertakings with significant market power, namely transparency, non-discrimination, accounting separation, access and price control including cost orientation. The Directive specifies that this is "a set of maximum obligations that can be applied to undertakings, in order to avoid over-regulation". The NRAs have to present a justification that the obligation is appropriate and proportionate in relation to the nature of the problem identified.

### **3.5 Economic issues raised by the new regulatory Framework for electronic communications**

The new regulatory regime has been presented as an approach which makes possible the transition from natural monopoly regulated markets to general competition law activities. However certain economists take a much more skeptical approach and present certain risks related to the new regime.

Martin Cave (2004) underlined the following risks:

- The risk to keep access prices low which may chill incentive to invest in alternative infrastructure, including alternative platforms based on cable, wireless and satellite.
- The fact that the multi-nature of the new regime involving interactions between the Commission and NRAs, runs the risk of creating delays and raising tensions, which incumbents or others will seek to exploit.

For A. Oldale and A. Jorge Padilla (2004), the new regulatory regime may impose obligations on large telecoms companies to supply inputs to new entrant, "even in situations where there would not be any grounds for intervention under competition law". The risk is therefore that regulatory interventions will go beyond the limits of competition law remedies.

These criticisms raised two fundamental points:

- To what extent the new regulatory regime is likely to result in less regulation than the old regime? It is clear that the application of the competition -law approach under the new regulatory framework may increase the number of markets to be regulated, since the markets are now defined based on competition-law approach and not based on the "telecom directives" as under the "old framework". Under the old regulatory regime, NRAs could impose ex ante obligations on operators whose market share exceeded 25 per cent as under the new framework, NRAs should impose ex ante obligations on operators only if

they are dominant within the meaning of Article 82. This new definition will have the effect of raising the threshold for ex ante regulation. Moreover, contrary to the "old framework", under the new framework, "regulatory obligations should only be imposed where national and Community law remedies are not sufficient to address the problem" (Rec 27, Framework Directive). Moreover, the periodic review of the list of markets to be regulated (Commission recommendation) will allow further limitation of the list of markets for ex ante regulation, taking into account the evolution of each specific market.

- To what extent ex ante regulatory intervention pre empts ex post competition law enforcement?

It could be argued that there is no possibility for Competition authorities to intervene in sectors regulated by national regulatory authorities, in particular for access prices which are directly regulated by NRAs.

In practice, competition policy interventions are possible even in a case of State monopoly, British Telecommunications, still acting under State monopoly had been found to abuse its dominant position by restricting the use of telex and telephone facilities (O.J. 360, 21.12.1982). What is the possibility for competition policy to intervene in network industries, economic sectors subject to ex ante regulation, in which member states play a major role through the decision making practice of the national regulatory authorities?

Despite the existence of sector specific regulation, the EU competition rules are applicable to all autonomous behavior by undertakings that prevent, restrict or distort competition. However, it has to be proved that this behavior is not only a result of pricing policies imposed by the national regulatory authority but also stems from the incumbent's deliberate strategy (section 4). If it is proved that the abuse stems from prices subject to sector-specific regulation, competition law decisions will refer to State measures(section 5).

#### ***4. Competition law – Abuse of dominant position in network industries***

Article 82 places obligations on undertaking holding substantial market power (SMP). Public authorities prohibit certain conducts of firms holding market power and intervene when, in a given market place, they observe customers exploitation or exclusionary practices or both.

- Customer's exploitation in the form of excessive pricing, reduction of output or discrimination between different types of customers.
- Exclusionary practices in the form of business practices seeking to exclude competitors from the market.

The competition law approach, contrary to the regulatory approach avoids direct regulation of undertakings, for example on prices or output of dominant firms. It relies on the self-regulatory effect of the market mechanisms and its main objective is to ensure that markets work properly and they are not distorted by anti-competitive conducts.

During the year 2003, the Commission adopted two formal Article 82 prohibition decisions regarding abusive pricing for the provision of telecommunication services as discussion below. These were the first decisions since the telecommunication sector was fully liberalized in 1998. In the postal sector, the Deutsche Post decision of 2001 raised the question of cross-subsidization and the application of predatory pricing in an industry that exhibit significant network effects. These decisions are particularly interesting since both deals with an economic sector subject to ex ante regulation. Despite the traditional reluctance of Competition law to enter into matters of pricing and the needs for enquiries into production costs, these decisions suggest a broader role for competition law in predatory pricing issues and the avoidance of cross-subsidies. They show the enforcement of competition law and sector-specific regulation being conducted hand in hand, with

competition law as the driving force (Henri C., Matheu M. and Jeunemaitre A., 2001).

#### **4.1 Margin squeeze – The Deutsche Telecom case**

Price squeeze has recently received policy attention in the context of regulated industries. Under full regulation when both wholesale and retail prices are regulated, the incumbent has no pricing freedom and a price squeeze is a regulatory price squeeze with a clear responsibility of the regulator. Under partial liberalization, when prices are partly regulated mainly under a cap regulation, the incumbent can squeeze competitors (Bouckaert Jan and Franck Verboven, 2004). On 21 May 2003, the Commission adopted a decision under Art. 82 regarding Deutsche Telecom's pricing policy for local access to the fixed telephony network (OJL 263, 14.10.2003).

The Commission found that DT charged higher fees to new entrants for wholesale access to the local loop than DT's subscribers paid for fixed line subscriptions. This discouraged new companies from entering the market and it reduced the choice of telecom services suppliers as well as price competition for consumers. The Commission's action was originated from complaints by numerous new entrants in the German telecommunications market.

In Germany, Deutsche Telekom ("DT") offered local loop access at two different levels. Besides the retail subscriptions to end customers, DT also offers unbundled access to the local loop competitors, which allows them direct access to end-users. DT is thus active in the upstream market for wholesale local loop access to competitors and in the downstream market for retail access services to end-customers. Both markets are closely linked to each other.

The Commission found that DT was abusing its dominant position through unfair prices. DT held a dominant position on both, the markets for wholesale

and retail access to the local loop. Regarding wholesale access, DT was the only German network operator having a network with nation-wide coverage. The other alternatives, which include fiber-optic networks, wireless local loops, satellites, power lines, and upgraded cable TV networks, were not yet sufficiently developed and couldn't be considered as equivalent to DT's local loop network. Regarding retail access, even after five years of competition, DT still had around 95% market share and the remaining 5% were divided up between a large numbers of DT's competitors.

The Commission's assessment revealed that DT charged competitors more for unbundled access at wholesale level than it charged its subscribers for access at the retail level. This constitutes a clear case of margin squeeze because it leaves new entrants no margin to compete for downstream retail subscribers.

DT contested having any freedom to avoid a margin squeeze, claiming that the regulator's decisions on the level of wholesale and retail access fees left DT with no scope for charging higher retail or lower wholesale access fees, or both, in order to avoid a possible margin squeeze.

However the Commission showed that DT, even if it was subject to price regulation, had the commercial freedom to terminate or to avoid the margin squeeze on its own initiative. The initial price cap system set up by the public authorities gave DT sufficient scope to restructure its tariff system in order to avoid any margin squeeze.

## **4.2 Predatory pricing: the Wanadoo case**

Predatory pricing follows the following pattern: a short run sacrifice in profits and a long-run recoupment of the losses. The objective is to identify a precise story of competitive harm (E.A.G.C.P., 2005). On 16 July 2003, the Commission adopted a decision against Wanadoo, a subsidiary of France Telecom for abuse of dominant position in the form of predatory pricing in broadband internet access services for general public.

From the end of 1999 to October 2002, Wanadoo, an owned subsidiary of France Telecom, marketed its ADSL services at prices which were below their average costs. The prices charged by Wanadoo were well below variable costs until August 2001 and in the subsequent period they were approximately equivalent to variable costs, but significantly below total costs.

Wanadoo suffered substantial losses as a result of this practice. The practice coincided with a company plan to pre-empt the strategic market for high-speed Internet access. While Wanadoo was suffering large-scale losses on the relevant service, France Télécom, which at the time held almost 100% of the market for wholesale ADSL services for Internet service providers (including Wanadoo), was anticipating considerable profits in the near future on its own wholesale ADSL products.

Wanadoo policy was fully aware of the level of losses. According to in-house company documents, the company was still expecting at the beginning of 2002 to continue selling at a loss in 2003 and 2004.

The abuse was designed to take the lion's share of a booming market, at the expense of other competitors. From January 2001 to September 2002, Wanadoo's market share rose from 46% to 72%, in a market, which experienced more than a five-fold increase in its size over the same period. At the end of the period, no competitor held more than 10% of the market, and Wanadoo's main competitor had seen its market share tumbling.

Those competitors for ADSL services, without the backing of France Télécom (as Wanadoo had), were unable to withstand the price pressure and would have been forced out of the market. One of them (Mangoosta) did in fact exit in August 2001.

The aim of a strategy of below-cost pricing (predatory pricing) is to remove competitors or to give the dominant operator enormous market power. Consequently, once to consumer's choice has been severely restricted or

completely removed, the dominant operator can use its stronger market position to increase prices.

After the abuse period, Wanadoo could have cashed in on reputation effects it would have gained. In the eyes of the general public, Wanadoo was the only company that would have succeeded in introducing technological innovation in an emerging market. In such a sector, the advantages of a first-mover strategy and high-tech profile are considerable.

Moreover, the French incumbent France Telecom undertook the technical development of ADSL and its subsidiary Wanadoo simply retailed France Telecom's product. France Telecom was the strategic architect of the ADSL industrial development in France and expected to attain positive net margin levels very quickly when Wanadoo's net margin levels were low. If France Telecom's strategy aimed to develop the ADSL market in general, France Telecom could have priced the wholesale products at a lower level, encouraging the entry of all competitors.

#### **4.3. Cross-subsidization in Non-reserved markets: Deutsche Post (O.J. L125 (27), 2001)**

In its decision, the Commission concluded that Deutsche Post's overall revenues in the reserved area (letter mail) exceeded its stand-alone costs, where as revenue from its mail-order parcel service was below the incremental cost of providing that specific service. After collecting mail-order parcels, Deutsche Post used the same infrastructure to process mail-order services that it used to process commercial parcel services.

The decision stated that "when establishing whether the incremental costs incurred in providing mail-order parcel series are covered, the additional cost of servicing that service incurred solely as a result of providing the service, must be distinguished from the common fixed cost, which is not incurred solely as a result of this service".

In order to establish predatory prices the decision proposed to distinguish between costs for network *capacity* and network *usage*. The costs incurred for providing network capacity to give everyone an *option* to ship parcels at a uniform is considered as part of DPAG's universal service obligation. Universal service obligation is defined as the obligation to serve as the "carrier of last resort". Mandating that a firm serve as a carrier of last resort forces this firm to hold capacity in reserve in order to meet demand at peak load. The costs that arise out of a company's obligation to serve as the carrier of last resort are appropriately treated as common fixed costs for the firm. On the other hand, the costs for actual usage of the network for offering product X are variable. In order not to be deemed predatory, prices have to cover at least this variable cost of usage. DPAG, for the period 1990 through 1995 charged prices for the delivery of mail order parcels which were below the variable cost for network usage. Indeed, the *incremental* costs are the costs arising of actual network *usage*. Incremental cost of a service X includes the variable costs in providing this service and any fixed cost that must be incurred on behalf of product X alone (the so-called "product-specific" fixed costs). Incremental costs do not include the common fixed costs.

The Commission considered that prices below variable costs for actual network usage cannot be justified, because the additional sales at this price make no contribution to maintaining the network capacity necessary to perform U.S.O.

##### ***5. Competition law applied to anticompetitive state measures in network industries***

According to Article 86(1), state-owned firms or firms which have been given special or exclusive rights by government are not exempted from competition rules. They may not collude, abuse their dominant position or receive unauthorized State aids. Article 86 is addressed to Member States and refers to State measures which are normally adopted through laws regulation, administrative rules or other instruments of public law. It guarantees that

member states shall neither enact as to maintain in force any measures contrary to the competition rules, in particular, Article 86(1) applies as regards State measures affecting the structure of the market if the resulting structure leads the undertaking to abuse.

However, condition related to public interest objective (article 86(2)) countervails the application of Article 86. It allows derogation from Article 86 for the achievement of general economic interest that the State entrusts the undertaking. This means that firms "entrusted with the operation of services of general economic interest, are in practice network industries (telecommunication, post, energy, water) and certain transport industries. Therefore, an economic analysis is necessary and this analysis has to weight the net cost of providing universal service obligation and the advantages inherent to the exclusive rights.

Just as in antitrust including Article 86, the issue of the justification for State aid covered by Article 87 and Article 88 is fundamental. From the point of view of economic efficiency, state aid are justified if used to correct certain failures even if they are often based on equity and social consideration, in particular for network industries subject to Universal Services Obligations, State aid received by the undertaking as compensation for the universal service cost must be analyzed. The judgment of the Court of Justice (24 July 2003), *Altmark* clarifies the conditions under which public service compensations are considered State aids, subject to a compatibility analysis.

As said, the structural reform started in the EU with the liberalization of network industries and the introduction of competition generated new forms of regulation, which differ from those that existed in the past. The liberalization focused on removing the monopoly status enjoyed by public undertaking in network industries.

The first steps towards an opening to competition of postal markets in the EU have led to an increased influx of complaints to the European Commission.

These complaints alleged that certain Member States have put into place a national legislation which is incompatible with Article 86 of the Treaty.

Concerning the behavior of Member States in the postal field, the Commission can deal with these issues in two different manners. Firstly, infringement procedures can be initiated against Member States that fail to comply with the provisions of the Postal Directive. Secondly, infringement procedures against the Member State under article 86 in conjunction with Article 82 can be introduced (Baratta R., Buigues P., Fehrenbach J., Johansson D., Lueder T., 2001).

In the postal sector, the vast majority of these complaints were within the two categories about monopoly extension and lack of independent regulator.

### **5.1 Monopoly extension:**

Following the entry-into-force of the first Postal Directive (10 February 1998) Member States have introduced a new legislation, transposing the provisions of the Directive into national law. However, some Member States have interpreted the Directive in a restrictive manner. For example, legislation increased the scope of the monopoly reserved for the incumbent operator. The Commission has adopted one Decision concerning such an attempt by a Member State to extend a postal monopoly – the “Hybrid Mail” case.

The decision followed a complaint lodged by several Italian SME’s which had established the electronic transmission and printing infrastructure necessary to provide the hybrid electronic mail service. Hybrid electronic mail service offers a contractual guarantee that items created and transmitted electronically arrived at a predetermined time. The complainants alleged that the delivery phase of the new hybrid electronic mail service had, as part of the transposition in Italy of the Postal Directive, been reserved for the incumbent operator. The Commission took the view that the delivery at a predetermined

time was a market which differs significantly from traditional delivery services that comprise the so-called general letter service under monopoly.

Of course, the Commission's decisional practice does not question the Member State's definition of services of general economic interest ("SGEI") and the financial equilibrium of the undertakings that are entrusted with SGEI. According to the Commission there was no objective justification for extending the general letter mail monopoly to include guaranteed time deliveries. Competition in day or time certain deliveries would not jeopardize the financial equilibrium of the incumbent operator.

Moreover the incumbent did not himself offer a guarantee for time-certain delivery as part of any of its postal services and therefore the incumbent would not suffer any loss of revenue.

Furthermore, the Commission's market analysis had revealed that day or time-certain deliveries satisfied a very special and limited demand concerning only time-sensitive mailings. Time-sensitive mailings were a new service which creates additional mail volume and does not replace demand from the general letter mail service.

## **5.2 Lack of independent national regulator:**

Some Member States have adopted legislation that fails to meet certain requirements of the Postal Directive. The Commission adopted one Decision which addresses this problem – the "SNELPD" case concerning an independent regulatory authority in the postal field in France.

The Commission received a complaint from the SNELPD, a trade association representing the majority of French mail preparations firms, directed against the French Government. Mail preparation firms offer a wide array of services ranging from the making up of postal items on behalf of large mail originators to the handing-over to the offices of La Poste of presorted mailbags.

Mail preparation may cover services performed in place of La Poste. These activities involve making up and placing items in mailbags complying with certain standards, sorting destination and delivering items to offices of La Poste. Due to its monopoly situation La Poste is in a position to impose on mail preparation firm's contractual clauses which contain price conditions and technical standards unilaterally determined by itself.

According to the jurisprudence of the Court of Justice, the mere fact for a Member State to have allowed such a situation of conflict of interest to arise is per se an infringement of Article 86(2) of the Treaty in conjunction with Article 82, irrespective of whether an abuse of dominant position by the postal operator actually occurs.

Another objection of the Commission to the French regulatory scheme was that the State, through the Ministry of Finance, monitors the activities of La Poste and its contractual arrangements with its commercial partners. Moreover, the States encompasses also the supervision of the financial interest of the State in this public postal operator. The Commission considered in its decision that this might affect the impartiality of the Ministry while performing its controls over La Poste and that the Ministry itself could be placed in a situation of conflict of interest.

Furthermore, the case presented a double conflict of interest, within La Poste as being the competitor and unavoidable partner of mail preparation firms, and within the Ministry as being both the watchdog of La Poste's competitive behavior and its sole shareholder. It is worth noting that the Commission position – as regards the necessity for Member States to ensure that the regulatory framework and the controls exercised on a public postal operator neutralize any conflicts of interest – stands, irrespectively and independently of the provisions of the Postal Directive.

Within these decisions, the Commission clearly showed that even when prices under examination are subject to sector-specific regulation, competition law

principles apply to ensure that the market works properly. However, if states measures lead the undertaking to abuse its dominant position, then member states might infringe competition law, more precisely Article 86 of the EC treaty.

## ***Conclusion***

In the recent years, EU is undertaking major reforms aimed at narrowing the scope of sector-specific regulation in network industries. These reforms have induced important and crucial debates about the scope of regulation in network industries opened to competition. Abolishing regulations and leaving market forces operating within general competition law approach were only parts of the solution adopted. New sector specific regulations were also put in place to promote competition. However, in markets previously dominated by state owned enterprises and totally regulated, the introduction of competition is a complex task (Perrot A., 2002).

In general, first, competition agencies apply an ex-post, harm based approach whereas sector-specific regulators apply an ex-ante prescriptive approach. Second, sector-specific regulators intervene frequently and require a large flow of detailed information on the sector from regulated entities while competition agencies rely generally on complaints and gather information only in connection with enforcement intervention. Third, sector specific regulators impose and monitor detailed conduct and behavioral remedies whereas competition agencies opt for structural remedies addressed to specific conducts. Fourth, sector-specific regulators are assigned broad range of objectives, including in some countries industrial policy considerations while competition policy agencies have a specific mandate in connection with consumer and total welfare.

In sectors of rapid change in technology like the telecommunication markets, traditional ex ante regulation can create major distortions and generate

additional costs. The new regulatory framework of the telecommunication industry based on competition analysis principles could be the appropriate ex ante regulation approach for any other network industries which still needs a regulatory intervention. The same competition policy philosophy may be the best way for regulatory intervention in network industries where still some form of public intervention is considered to be useful in term of economic efficiency. Of course, certain regulators would not agree that the new regulatory framework of the telecommunication industry is a good example to show how regulation and competition are working together and they might argue that it is an example where competition policy has tied the hands of regulators in designing contracts to create competition. For certain economists, at the opposite, the new framework creates a situation where regulatory intervention likely will go beyond the limits imposed by competition law.

However, despite the existence of a regulatory framework based on competition law principles, the antitrust rules are still applicable. If it is demonstrated that the business strategy of an undertaking (as pricing policy of an undertaking) is deliberate strategy and not imposed by a national regulatory authority or a member state, relying on ex post regulation is still appropriate.

In the postal sector, which is lagging behind in the liberalization process, compared to other regulated network industries, there is the concern that opening reserved postal activities would undermine the performance of universal service obligations. That raises the issue of measuring the cost of the universal service obligation which is a complex task. In the postal sector, the Commission adopted decisions concerning the attempts of Member states to extend the postal monopoly and the failure of other member states to address the problem of an independent regulatory authority in the postal field

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