FRANCO PAPANDREA: NOTES

- Convergence has been defined in a variety of ways, but it essentially refers to the increasing substitutability of technological platforms to deliver different communication services.

- Before the rapid technological changes of recent years, the communications sector was characterised by distinct markets with little interaction between them.
  - For example, telephony, data and broadcasting services were delivered over separate networks subject to separate regulatory arrangements.

- Technological developments, particularly digitisation, have made transmission facilities increasingly interchangeable thus undermining the traditional distinctions between markets.
  - In addition, new technology has opened up opportunities for the development of new services using existing infrastructures (e.g., ADSL on existing copper pairs).

- The process is continuing at a rapid rate making it difficult, if not impossible to predict the likely structure of new and emerging markets.

- At least in Australia, convergence of markets has not been accompanied by convergence of regulatory arrangements.

- Distinct regulatory arrangements continue to apply to:
  - Telecommunications services
  - Free to air broadcasting (radio and TV)
  - Pay Television
  - Other forms of broadcasting (narrowcasting services, datacasting and multichannelling)
  - Internet.

- As markets converge, therefore, there is a considerable risk that essentially the same service will face different regulatory burdens depending on the delivery.
  - Different treatment will lead to potentially serious distortions of investment decisions and industry efficiency.

- At a general level, the notion of converging markets suggests an increase in competition and a consequential reduction in market power. In reality, however, the
outcome is not so clear-cut and considerable difficulties may result for regulation and regulatory authorities.

- Evaluation of market power in converging markets may be difficult. While the degree of market power in the pre-existing markets may give an indication of possible outcomes in circumstances where convergence does not lead to substantial changes in the attributes of products, it may be of little help in assessing outcomes when new products or services characterise the converged market.

- There are at least three distinct possibilities that can emerge from the convergence of previously distinct markets depending on the structure of those markets:
  - Dominant player in one market may lose its dominance or become less dominant in the expanded converged market;
  - Dominant player in one market may retain its dominance in the converged market (could arise where the second market is made up of several major players of about equal size, including the dominant player in the first market); and
  - Non-dominant player in both previously-competitive markets emerges as the dominant player in the converged market (could arise where one firm is a significant player in both competitive markets while the competitors are significant players only in one of the pre-convergence markets).

- There are also several implications for regulatory policies including:
  - Regulation should not impede the process of market change that flows from convergences unless the changes clearly lead to undesirable concentration of market power.
  - Regulation must avoid the situation where competing firms delivering highly substitutable products or services are treated differently. Efficiency requires neutral regulatory treatment of different technologies. A focus on regulation of services rather than their delivery technology will help this.
  - If competition increases as a result of convergence, pre-existing regulation needs to be reviewed. It should not be assumed that pre-existing instruments continue to be necessary or valid in the converged market. When markets with different regulatory treatment converge the question arises as to which treatment should apply to the converged market. If regulation is needed, the less intrusive of the two should be favoured as the starting point for evaluation of further liberalisation.
  - If new services emerge from convergence, the necessity of regulation needs to be considered carefully if growth is not to be obstructed. With completely new services, market power is not usually an issue and the need for regulation should be low.
  - If new services develop that compete with existing services subject to regulatory control, regulatory authorities need to address the problem of what kind of controls should apply. New services may erode the effectiveness of obligations such as USO contribution currently collected from telephony service revenues. For example, should VoIP telephony
services be subjected to USO levy and, if so, how will such services be identified for the levy?
  o Convergence will also increase uncertainty. New investment may become more risky particularly if a different regulatory treatment is likely to apply in a merged market or if substitute services are likely to be treated differently.

• Substitutability or interchangeability of use of products or services is critical to the definition of markets. The key analytical tool for determining substitutability of products and services is cross-elasticity of demand.
  o Essentially what is being assessed is to what extent a price change in one product will induce consumers to switch their demand to another product. A significant shift in demand implies that the two products are close substitutes and consequently would be considered to be in the same market.
  o On this basis, the market is defined as the smallest area of product, functional and geographic space within which a profit-maximising monopolist can impose a small but significant and non-transitory increase in price (SSNIP). This is often referred to as the price-elevation test.

• A variety of additional complementary factors are used to assess the level of competition a market. For example, the ACCC includes:
  o Market shares (as an indicator of the degree of concentration)
  o Market behaviour and outcomes (as an indicator of potential market power)
  o Vertical and horizontal integration (indicator of capacity to leverage power in a related market)
  o Barriers to entry (indicator of contestability) and
  o Dynamic characteristics of the market such as market growth, innovation, product differentiation including likely effects of convergence.

• When new technologies or products are involved in converging markets there are usually insufficient data available for the estimation of elasticities or for the conduct of other rigorous tests. This forces assessment of market power to rely on less formal assessments.
  o Some would argue strongly that traditional measures are inadequate for the assessment of market power and competition in technology-driven markets (e.g., Pleatsikas and Teece, 2001) because they are likely to lead to market definitions that are too narrow.
  o It is also argued that traditional frameworks for assessment of markets are static in nature and consequently may be inappropriate or misleading in markets undergoing rapid technological change.
  o With changing markets potential competition may be more important that existing competition. Of course, potential competition is not easy to assess.
  o Considerable care should be exercised in defining converging markets. If too narrow a definition of market is adopted there is a risk that the test
may reveal the likely existence of market power where such power does not really exist. A too wide a definition would have the opposite effect.

- It is important, therefore, that regulators should not rely solely on traditional tools to define markets, but should complement their use with qualitative analysis.

**Some Specific Examples of Problems**

Look at some examples to highlight the difficulties of defining markets and market power rather than discuss the merits or otherwise of the decisions or outcomes. The following examples are indicative of some of the major difficulties:

- Foxtel-Australis merger proposals
- ULLS declaration and ADSL competition notice
- Bundling
- Digital TV/Datacasting policy

**Foxtel-Australis Merger Proposals**

This case illustrates some of the difficulties faced by regulators in defining market power in a changing market. It is an example of mixed technology related considerations in a market where different services could be delivered over the same network.

In 1996 there were three main providers of Pay TV services.

- Australis Media which used a combination of satellite and MDS delivery platforms. The use of satellite technology by other providers was proscribed by law until the end of June 1997.
- Foxtel (50 per cent owned by Telstra) using a HFC cable delivery platform primarily in capital cities; and
- Optus Vision (fully owned by C&W Optus) using a HFC delivery platform primarily in capital cities. Optus was also using its cable for the delivery of telephony services.

The ACCC opposed two proposals for the merger of Australis Media and Foxtel in 1996 and 1997. On both occasions the ACCC concluded that the merger would have resulted in substantial anti-competitive effects in three markets:

- the supply of Pay TV services;
- the supply of local telephony infrastructure and services; and
- the supply of broadband infrastructure.

The ACCC noted the difficulty in distinguishing between media markets because “the rapid growth of alternative forms of service provision means that market boundaries may change and … new markets may emerge in the near future.”

The ACCC’s focus on the different characteristics of Pay TV and FTA TV lead to a rather narrow conclusion that Pay TV was a distinct market (in part this was influenced
by the different regulatory regimes applying to Pay and FTA TV). Consequently the merger was seen as substantially reducing competition in the Pay TV market.

However, the Commission was also concerned about effects that the merger was likely to have beyond the Pay TV market.

- In the telephony market Telstra’s 50 per cent ownership of Foxtel was considered as an important element of Telstra’s defence of its local telephony business as well as having a major role in the development of its new broadband business.
- Because of synergies between marketing Pay TV and telephony, competition in the marketing of local telephony services over broadband cable networks would be likely to be damaged and thus likely to hinder the developing competition in the local telephony market.
- In relation to broadband, the Commission concluded that the merger was likely to have had long-term implications for the future of competition in the provision of broadband infrastructure and possibly in the delivery of broadband services using that infrastructure.

An additional reason for opposing the 1996 merger proposal was the first-mover advantage that would have accrued to the merged entity because of its capacity to use satellite and MDS technology in areas where Optus Vision had not rolled out its cable and was prevented from reaching until at least July 1997 through satellite.

**ULLS declaration and ADSL Competition Notice**

The ACCC declared the unconditioned local loop service (ULLS) in July 1999. The service is a necessary input to the competitive provision of new voice and data services, including ADSL over the fixed-line customer access network (CAN). As the owner of the CAN, Telstra is the predominant supplier of ULLS as well as the largest supplier of ADSL services, including wholesale ADSL services for resale by its competitors.

Because of concern in the industry that Telstra might have been attempting to extend its market power by securing a substantial first-mover advantage in the supply of ADSL, the ACCC sought and obtained written assurances by Telstra that it would not introduce its retail ADSL service ahead of making ULLS and wholesale ADSL services available to competitors. While Telstra introduced the services simultaneously in August 2000, it nonetheless sought to use its market power to frustrate competitors’ entry to the market. Several disputes on ULLS pricing were referred to the ACCC. In addition, the ACCC was concerned about Telstra’s conduct with the pricing of the wholesale ADSL service and eventually issued Telstra with a Competition Notice one year after the introduction of the service. Following the issue of the competition notice, it still took Telstra nine months to comply with it. The ULLS pricing disputes were also settled about the same time. In this case, Telstra was able to exert its market power to gain a significant first-mover advantage by frustrating its competition for almost two years.
Bundling

Bundling of product and services can have considerable benefits to both providers and consumers, but it may also be used as an anticompetitive tool to the disadvantage of consumers. Much of the effect of bundling depends on the nature and structure of the markets for the bundled products or services.

In general, bundling can improve efficiency by:
- allowing suppliers to exploit economies of scope in production and distribution;
- allowing suppliers to maximise profits and increase efficiency by using discriminatory pricing to capture an increased level of consumer surplus; and
- providing a cost-effective way of marketing services to consumers.

In competitive markets many of these benefits are passed on to consumers.

In markets where a provider enjoys market power in at least one of the bundled goods or services, bundling can have considerable anticompetitive effects. The anticompetitive effects include strategic use of bundling to stifle competition, leveraging of market power from one market to another, and pricing that could be predatory or result in a vertical price squeeze.

Because these effects depend on the particular circumstances in which bundling takes place, it is difficult to determine a regulatory approach likely to have general application. What may be necessary, therefore, is the development of a set of principles that will be applied to different circumstances and to rely on a case-by-case consideration of how those principles are actually applied.

Digital TV Policy/Datacasting

This is an example of how not to proceed with regulation of new and emerging markets.

The policy for the introduction of digital television in Australia is the most recent chapter in a long history of broadcasting regulation designed to stifle competition and protect the interests of incumbent. This is in stark contrast with telecommunications regulation whose primary objective is to promote the long-term interests of end users. With convergence, the two regulatory regimes are set to clash with each other. The worrying thing is that where there is a clash policy-makers may act to impose the restrictive broadcasting regulation on new services that are likely to compete with FTA television.

The main anticompetitive effects of the digital policy are:
- a ban on any new free-to-air television services until at least 31 December 2006;
- mandating a high definition television standard that effectively locks up all the available broadcasting spectrum until the digital conversion is completed;
- a ban on the use of the digital spectrum for multichannelling; and
- the spectrum not required for digital conversion by the FTA operators was to be used for an arbitrarily defined new service (datacasting). (Datacasting was banned
from having any features likely to make it even marginally competitive with FTA services. The result was that no one was interested in bidding for the datacasting licences.)

By any rational standard, the policy has been a failure with undoubtedly substantial costs in forgone benefits to society that a pro-competitive policy would have generated.

Reference