Consultation on the

"Revised ERG Working paper on the SMP concept for the new regulatory framework (October2004)".

Introduction

At its eleventh ERG plenary meeting on December 2 - 3 2004, the Group decided to publicly consult on a revised version of its working paper on the concept of SMP. This paper represents Vodafone's contribution to this consultation.

Our comments follow the format of the working paper. We remain sceptical of the claim that the jurisprudence of the European Courts and Commission Practice can or should be extended through 'common sense interpretation' on the part of the ERG. We have particular concerns about the introduction of new criteria not previously cited in the relevant EU case law or the SMP Guidelines.

1. 'Common sense interpretation' does not mean substitution of existing law

The working paper expressly recognises, in both the Introduction and paragraph 3 that it addresses criteria which go 'in some parts beyond' the existing criteria identified under the jurisprudence of the European Courts, and the practice of the European Commission. The ERG cannot substitute its own views in this way, having regard for the obligation only to make any designation of SMP in accordance with Article 15(2) of the Framework Directive and Community competition law principles of dominance. Recital 25 of the Framework Directive states clearly that:

> *"the definition used in this Directive is equivalent to the concept of dominance as defined in the case law of the Court of Justice and the Court of First Instance of the European Communities".*

We detail below those areas in which we believe the ERG have ventured beyond 'interpretation' and risk instead substituting their own views for those already well-established by lawmakers and the competent Community Courts. Such an option is not open to the ERG or its members.

Paragraph 6 refers to the "phase" of a market, implying that NRAs can selectively apply different criteria at different stages in a market's development. Whilst it is undoubtedly the case that the courts have regarded the consideration of cumulative criteria as being informative rather than definitive[1] and Vodafone agrees that NRAs should be dissuaded from pursuing a mechanistic 'check list' approach; it is also important that NRAs provide adequate reasoning behind their adjudication of the various criteria and relative reliance placed upon each. It is not obvious to us that the criteria to be used are different although in nascent markets there will often be a deficit of information about future developments and therefore the presumption ought to be to desist from regulating ex-ante[2].

The working paper should emphasise the importance of a forward-looking assessment of the market when considering any and all of the criteria. Given the ex ante nature of the regime this is a legal pre-requisite and a failure to do so renders any conclusions unsound. It also should be emphasised that dominance is a position that cannot be transitory but must be sustainable over time. This was clearly established in Airtours v Commission[3] and so cannot be ignored[4]. As presently drafted the working paper fails to address the difficulties in inferring future competitive conditions from past or current conduct. This is precisely the area where the ERG must depart from Article 82 (although not the EC Merger Regulation, which is also forward looking), yet it receives no consideration in the document at all.

Criteria for assessing single dominance

i .Criteria already identified in SMP Guidelines

Paragraph 7 asserts that positive correlations between market shares and individual price cost margins, with reference being made in footnote 3 to the Lerner index. This is, in our view, an unhelpful and inappropriate point of departure for a consideration of SMP. Price-cost margins have not generally been a major consideration in competition law assessments of dominance for the very good reason that such margin analysis is difficult to undertake and can yield misleading results, especially where multiple services are supplied in a network environment with significant fixed and common costs. It is unfortunate that paragraph 7 thereby seeks a 'common sense' extension of competition law precedent which is unwise as well as unwarranted[5].

In particular, Lerner indices in telecommunications markets characterised by substantial fixed and common costs may provide poor evidence of competitive conditions. It is not illuminating that certain services make a higher contribution to cover fixed and common costs than others in multi-service firms. This is common in many industries where different products face different demand conditions.

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1 Hoffmann-La Roche v Commission Case 85/76 [1979] 3 ECR 461 and Airtours v Commission Case T-342-99 [2002] II 2585

2 see the forbearance provision contained in the SMP guidelines at paragraph 32. (2002/C 165/03)

3 T-342-99 [2002] II 2585 paragraph 62

4 see also paragraph 20 of the SMP Guidelines

5 The ERG themselves note in paragraph 20 that the chain of reasoning between price cost margins and dominance via market shares is itself not 'clear cut'.

Even if such an exercise could be reliably undertaken, we also argue that high firm-specific margins need not be indicative of market power and that only a consideration of margins in the market as a whole over the investment cycle is likely to yield useful information – and then only to prompt further enquiry. [6] The fact that one firm is able to charge higher prices or earn higher returns than its competitors can be due to a wide variety of reasons, only one of which is market power. Superior efficiency, a superior service, reliability, a wider portfolio of services, a more desirable brand are others. It is wrong to suggest that the only correlation of profitability is with market power.

In the second subparagraph of Paragraph 7 the paper refers to an erosion of market share as a "natural" effect of the opening of monopolistic markets. There is no such 'natural' effect if this implies, as the ERG suggest, that such developments should be discounted in any assessment of SMP. Loss of market is always likely to constitute evidence of competition – and loss of share in recent periods is likely to be indicative of the ability of entrants to capture further share and exercise competitive constraints in the future.

Paragraph 8 omits consideration of whether these factors may be short-term sources of competitive advantage that can be replicated or overcome by rivals on a forward-looking basis (as indeed can "technological superiority" referred to at Paragraph 10). As mentioned above, it is clear from Airtours and other case law from the European Courts that dominance must be sustainable over time rather than being short-term first mover advantage and the two cannot be confused. Explicit reference to barriers to expansion (or the absence thereof) should be made in this context.

Paragraph 11 notes that countervailing buyer power is often 'more meaningful in wholesale markets' than retail markets. It should be recognised, however, that some retail customers in some markets may have greater bargaining power than many small wholesale customers and it cannot therefore be concluded that this *is never* a consideration in retail markets. This is evidently the case in respect of large corporate customers for telecommunications services. In addition, in the Airtours decision the CFI explicitly states at paragraph 274 that the presence of price sensitive consumers who, although acting in isolation, can and do switch suppliers can exert significant countervailing power.

ii. Criteria not identified in SMP Guidelines

We have indicated above the difficulties in considering 'excessive prices' or comparing price-cost margins with some 'competitive benchmark' in multi-product firms with substantial fixed and common costs, as is the case in most telecommunications markets. We have noted that conventional competition law analysis of dominance places little reliance upon such exercises as a result. Paragraph 20 itself recognises some of these difficulties and this is supported by economic theory. In a recent article concerning excessive pricing the economists Jorge Padilla and David Evans state:

[6] See for instance the comments of the UK Competition Commission in respect of call termination "when deciding whether persistently high profit levels are an indicator of ineffective competition, it is necessary to consider the circumstances in which such returns are earned…Our view is that the profitability of each MNO over the past few years is not critical as an indicator of competition in any particular part or parts of the wholesale or retail market." Reports on references under section 13 of the Telecommunications Act 1984 at paragraph 2.161.)

"competition is rarely static and industries often exhibit significant economies of scale and/or scope. In dynamic industries, where typically fixed costs are high and incremental costs are low, the "competitive" prices are not given by marginal costs. Rather, it is efficient to charge prices according to customers' willingness to pay so as to cover fixed costs in the least output restricting way. In short in these industries it is impossible to define "competitive" prices using only information on costs."[7]

Paragraph 20 fails however to caution properly or sufficiently against false inferences from firm specific profitability analysis, as mentioned above. It notes that market leaders can legitimately earn superior firm specific profits over a sustained period of time. Such profits provide the signals for entry and the benchmark for rivals, which characterise properly functioning competitive markets. NRAs are poorly placed to adjudicate whether market-beating returns derive from superior innovation, superior operational performance or from the exercise of market power, even if they are able to measure such returns.

Paragraph 23 concludes the section on single firm dominance with the following sentence:

> *"If this assessment [using the criteria discussed] reveals an imbalance in the relevant characteristics to one company's advantage, this could mean that the company's scope for using competitive parameters or market strategies can no longer be adequately restricted by its competitors".*

Again, Vodafone suggests that this sentence ought to be deleted or redrafted to (a) emphasise the need for a forward looking assessment and (b) emphasise the importance and practical difficulties in distinguishing between legitimate competitive advantage and market power (and the consequent danger that ill judged ex ante intervention thereby undermines the very incentives which drive competitive activity).

Criteria for assessing joint dominance

Paragraph 25 refers to the CFI judgement in Airtours v Commission where collective dominance is defined as a situation where it is economically rational and preferable for firms to adopt, on a lasting basis, a common policy with the aim of selling at above competitive prices. We point out that the CFI also found the need for it to be not only theoretically rational and preferable to adopt such a common policy but *possible* to do so, i.e. that mechanisms exist in order to perpetuate that policy[8]. Indeed, this is the key consideration.

However, the ERG appears to take the view that the test in Airtours is wrong when it states in the Working paper at paragraph 25:

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[7] David Evans and Jorge Padilla, *Excessive Prices: Using Economics to Define Administrable Legal Rules* August 2004, forthcoming in Journal of Competition Law and Economics (2005) at p. 6.

[8] See Airtours paragraph 61

> *"…this shall not be interpreted as a final finding, but merely as a fact that jurisprudence of the European Courts on joint dominance is evolving and hence has to be taken in account when assessing dominance."*

As mentioned above, NRAs are bound by the terms of the Framework Directive, which explicitly states, in Article 15 and Recital 25, that NRAs are also bound by the case law of the ECJ and the CFI on dominance. The judgement in Airtours provides a clear statement of the law on joint dominance as it currently stands and the ERG cannot suggest to its members that they flout the law as determined by the CFI.

Generally, the discussion of joint dominance in paragraphs 24-41 ignores the dynamic aspects of market developments that characterise many telecommunications markets. Early attempts by NRAs to explore joint dominance[9] find NRAs attempting to argue that markets, in which SMP was not previously found and which were therefore previously effectively competitive, have changed so as to give rise to new incentives and mechanisms for tacit collusion. NRAs have attempted to identify the conditions that have changed over time, but have rarely explained why or how firms were able to agree tacitly to forbear from further competition, having previously been unable to do so. It is not sufficient for NRAs simply to list criteria which have changed – we believe that NRAs must provide a dynamic and economically plausible explanation as to how firm incentives and conduct can change so profoundly and how they are now such as to produce stable and enduring equilibriums when none existed before. Vodafone contends that this is a necessary requirement for any proposed NRA finding of joint dominance – and one that NRAs have failed to fulfil thus far. This is exacerbated by the lack of any forward-looking analysis and a tendency to dismiss, without due consideration, the impact of new or imminent entry or technological changes. The working document should make explicit reference to this requirement in the context of markets previously held by NRAs to be competitive.

Vodafone disagrees with a number of the ERG's views on factors that might be relevant to a joint dominance analysis. For example, the statement in paragraph 29 that strong growth increases the incentives to collude. This is simplistic. Strong growth in a market makes it both more difficult to detect cheating and means that the gains from cheating can be greater. The overall implications are therefore ambiguous. It is also incorrect to state in Paragraph 41 that price movements in a narrow range are per se evidence of collective dominance. There may be a number of reasons why prices move in a narrow range, the most obvious being that costs do not move. NRAs will need to consider cost trends before inferring anything from such evidence.

[9] See COMREG (Ireland) notification under Article 7 of the Framework Directive entitled Wholesale Mobile Access & Call Origination in Ireland (IE/2004/0121) and see ANALYSE DES MARCHES Accès et départ d'appel sur les réseaux mobiles published by ART (France) on 17th December 2004

Further possible indicators of market problems.

Paragraph 42 is plainly wrong in stating that evidence of previous collusion is an indicator of market failure in a prospective analysis. The approach articulated is simplistic and without foundation. Footnote 11 of the working paper is also wrong insofar as it refers to collusive agreements under Article 81, which would generally be expected to constitute evidence that the market structure cannot reach tacitly collusive outcomes – the fact that an explicit agreement is necessary to enforce an agreement would tend to mean that the market does not create the required common incentives and retaliation mechanisms for joint dominance.

The last sentence of paragraph 44 is ambiguous and should be deleted. Telecommunications markets cannot function without interoperability and to suggest that this is undesirable is clearly wrong. If the ERG is not to delete these vague references to the role of 'calling party pays' and 'international roaming agreements' in understanding 'the source of market failure and competition problems', Vodafone request that footnotes are provided to expand upon the nature of the ERG's precise concerns. Vodafone has previously asked the ERG to reconsider vague and unsubstantiated suggestions (in its Remedies Document) that 'calling party pays' arrangements and on-net pricing allow large mobile operators to 'tip' markets and exclude competitors, including price squeezing fixed operators. Subsequent analysis by competition authorities such as Ofcom, the Spanish Competition Court and the Commission itself[10], has shown this to be unfounded.

We also believe that any detailed analysis of international roaming markets – which the members of the ERG is only now doing - would demonstrate that this reference is also unfounded. We urge the ERG to complete such analysis *before* making any reference to such considerations in this working document, rather than prejudge the issues.

Paragraph 45 refers to customer surveys. Whilst useful, these should be approached with caution and cannot substitute more sophisticated (but perhaps more difficult) analysis of the demand side constraints posed by buyers on a forward looking basis.

Wholesale/Retail Market interrelationship

Vodafone notes that the working paper does not address the question of where a market is competitive at a *retail* level, there might nonetheless be an absence of competition (justifying *ex ante* regulation) at the *wholesale* level (i.e. no SMP downstream but SMP upstream). Ensuring effective competition at the retail level is a fundamental objective of the regulatory framework. Interventions by NRA's must be intended to realise the fundamental objective of achieving effective competition in the retail market.[11] This same approach is adopted by the ERG in its Remedies Document where it sets out at pages 80 and 81 that the imposition of regulatory remedies at the wholesale level, such as mandated access, will not be warranted where the downstream /retail market is already effectively competitive. Vodafone believes this position should be clearly restated here.

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[10] See Ofcom decision of 21May 2004 on suspected margin squeeze (case CW/00615/05/03), and see the decision by Tribunal de Defensa de la Competencia Espana (Expte. 572/03, UNI2 Y WORLDCOM/VODAFONE) dated 22nd December 2004 and the European Commissions actions in the KPN price squeeze case.

[11] See Article 12 (1) of the Access Directive, which states that, an NRA may intervene at the wholesale level to ensure a "sustainable competitive market at the retail level".

The only circumstances under which NRA's may find SMP upstream but not downstream is where competition **only** exists downstream due to the presence of regulation in the market or an upstream market (for example in fixed broadband services where retail competition to a large extent depends upon access to the local loop, because of the lack of alternative infrastructure).

Implications of a forward-looking analysis

Vodafone believes that a proper forward-looking analysis of SMP will result in one of four scenarios: -

- **Case 1** Uncompetitive both now and in the foreseeable future (SMP firms throughout period);

- **Case 2** Market found to be uncompetitive now (with SMP firms) but prospectively competitive on forward looking basis;

- **Case 3** Competitive both now and in the future (no SMP firms throughout period); or

- **Case 4** Competitive now but with a trend to suggest that it might become uncompetitive in the future (no SMP now, but risk of SMP firms in future).

Vodafone contends that under the Framework Directive and applicable EU case law, only **Case 1** can lead NRAs to impose ex-ante regulation.

Case 2 is not equivalent to dominance as set out by the CFI in the Airtours decision.

In **Case 3** no issues arise.

Case 4 which we believe highly improbable in practice, in either a single or joint SMP context[12] - should be governed by a predisposition against 'just in case' intervention and against ex ante intervention generally. NRA's can revisit at the next market review. This would properly reflect the 'deregulatory bias' that is embodied within the Framework Directive itself. We believe that the ERG working document should expressly address this issue – it fails to do so at present.

[12] We indicate above our scepticism of NRA claims that previously competitive markets can alight upon tacitly collusive equilibriums as they develop over time. This is a possible, but improbable outcome. The emergence of a singly dominant firm in a market previously characterised by competition would appear to rely upon assumptions of 'tipping' that are now (rightly in our view) also treated with scepticism by most competition authorities.

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Please address any comments or queries on this document to

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